

California State Lottery:

**Opportunities Exist To Improve Planning,
Reduce Administrative Costs, and
Increase Sales Efficiency**

August 1996
96107.1

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CALIFORNIA STATE AUDITOR

August 22, 1996

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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the California State Lottery (lottery). Our review focused on whether the lottery's strategic planning efforts, administrative functions and expenses, mandated audit activity, and Scratcher product distribution system are effective and efficient. This report concludes that the lottery can further improve its annual planning process and it needs to prepare a long-term strategic plan. In addition, the lottery should continue its efforts to monitor and reduce its administrative costs. Also, the lottery can improve its Scratcher product distribution system by using its sales staff more efficiently. Finally, the State Controller's Office needs to provide better documentation of its charges to the lottery and ensure its audit work is valuable, timely, and not duplicative.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Enclosure

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Summary

Audit Highlights . . .

The California State Lottery:

- ☒ *Has improved its annual planning process but more should be done, including fully integrating its divisional plans, setting benchmarks for performance, and developing a long-term strategic plan.*
- ☒ *Needs to continue to reduce administrative costs to compensate for the loss of Keno and the Scratcher vending machines.*
- ☒ *Can be more efficient and effective in its sales efforts by more fully utilizing telemarketers, concentrating its sales representatives' efforts, and equalizing incentive programs.*

Finally, the SCO needs to provide documentation of its charges to the lottery and ensure its audit work is valuable, timely, and not duplicative.

Results in Brief

The California State Lottery (lottery) originated with the passage of Proposition 37 in November 1984. The primary purpose of the proposition was to provide additional moneys to benefit education without the imposition of additional or increased taxes. During fiscal year 1995-96, the lottery generated revenues of nearly \$2.3 billion from its five on-line games and a variety of instant ticket games. Under the provisions of the Government Code, Section 8880.4, lottery revenues must be allocated as follows: 50 percent to be returned to the public as prizes, at least 34 percent to public education, and no more than 16 percent for the payment of expenses of the lottery.

This review focused on the lottery's strategic planning efforts, its administrative functions and expenses, mandated audit activity, and Scratcher product distribution system. During our review, we found:

- The lottery has made improvements to its strategic planning process. Specifically, the lottery moved from developing a sales-oriented annual business plan to one that incorporates activities of all of its operating divisions. However, the lottery can enhance its planning process by more fully integrating its overall objectives with its divisional objectives, developing benchmarks for its Scratcher game sales objectives, and identifying required resources for all planned activities. Furthermore, the lottery needs to develop a long-term strategic plan.
- The lottery's preliminary administrative expenses for fiscal year 1995-96 were within the stipulated limit of 16 percent of total annual revenues. Over one-half of these expenses are related to direct game costs that vary with changes in its sales and are costs over which the lottery has little discretion. However, with the recent loss of the Keno game and the Scratcher vending machines, the lottery must continue to identify ways to reduce its operating expenses.

- Over the period of time the lottery has been in existence, the State Controller's Office (SCO) has charged it \$29 million for audit and claims processing services. However, the SCO has provided little documentation to the lottery to support these charges. Further, the SCO's audit reports are of limited value to the lottery, and its planned audit work for fiscal year 1996-97 may duplicate work performed by the lottery's contractors.
- Merely comparing the lottery's administrative costs as a percentage of sales to those of other states is not a reliable benchmark because of underlying factors that impact this calculation. When gaming mix and other factors are taken into consideration, California's lottery operations are similar in many respects to those of other state lotteries. However, in the area of the number of sales representatives and telemarketers, our survey of ten other state lotteries supported our conclusion that the California lottery may not be efficiently using its sales staff.
- The lottery's Sales Division primarily uses district sales representatives and telemarketing representatives to maintain an adequate retailer network to provide steady increases in sales and revenue. However, the lottery can make its product distribution process more efficient by eliminating duplication of effort, focusing the efforts of its district sales representatives to working with retailers to increase their sales to consumers, and equalizing the incentive programs that it offers to its district sales representatives and telemarketers. Further, the lottery should rely on its telemarketers as the primary contact with its retailers because order gathering by telemarketing is more efficient than by personal visits.

We plan to issue a separate report on the results of our analysis of the lottery's use of information technology at a later date.

Recommendations

To further improve its strategic planning process, the lottery should integrate its organizational objectives with its divisional objectives in its annual business plan, prioritize its organizational goals and objectives, and document the communication that will be needed to implement activities involving resources from more than one division. In addition, the lottery should expand its use of benchmarks by establishing sales targets for individual Scratch games or game products,

documenting the benchmarks that support the sales goals for major game categories, using the benchmarks to evaluate the performance of games, and implementing changes to planned activities as necessary.

To effectively manage its operations, the lottery should develop an adequate long-term strategic plan and modify it as needed to accommodate changes in its business environment.

To fulfill its responsibilities related to its administrative expenses, the lottery should continue to take aggressive action to monitor and reduce its administrative spending. In addition, the lottery and the SCO should cooperate in improving the communication between the two departments. The SCO should use separate codes for its field audit costs related to monitoring, electronic data processing audits, and general and administrative overhead. Finally, the SCO should carefully assess the audit work it plans for fiscal year 1996-97 to ensure that it is not duplicative of existing work.

To improve the efficiency of its Scratcher distribution process, the lottery should consider reducing the number of retailers that are routinely visited by district sales representatives and redirect their responsibilities to work primarily with retailers that have the potential for increased sales. If the lottery does this, it may be able to reduce the number of its district sales representatives and thus lower its cost of sales. In addition, the lottery should consider using its telemarketers as the primary point of contact for the majority of its retailers, mail information on new Scratcher games to the retailers rather than having the district sales representatives deliver them, and modify the sales incentive programs offered to district sales representatives and telemarketers for equability. Finally, the lottery should consider these alternatives during the implementation of the Scratcher automation project to take advantage of any additional opportunities to make its product distribution system more efficient.

Agency Comments

The lottery generally concurs with our recommendations and suggestions as to how the lottery can improve its planning. In addition, the lottery stated that it will continue to closely monitor its expenses, as well as restructure and rebuild its organization. Finally, although the lottery does not fully agree

with our conclusions related to increased efficiency of its Scratcher distribution process, it will continue to evaluate and implement various programs to determine the most efficient, effective, and economical product distribution process.

The SCO believes that the recommendations contained in our report are supportive of its direction, mission, and priorities. In addition, the SCO stated that in May 1995, it recognized the need to improve its relationship with the lottery and that progress had been made over the past year. However, the SCO disagrees with our assessment of the value of the SCO's past audit efforts and its planned audit activities.

Introduction

The California State Lottery (lottery) originated with the passage of Proposition 37, the State Lottery Initiative Constitution Amendment and Statute (lottery act) in November 1984. The primary purpose of the lottery act is to provide additional moneys to benefit public education without the imposition of additional or increased taxes. The lottery act requires the lottery to produce the maximum amount of net revenues to supplement the total money allocated for education in California.

Organization of the California State Lottery

The lottery act states that the lottery shall be administered by a five-person commission appointed by the governor with the concurrence of the Senate. Commissioners are appointed for five-year terms. At least one of the commissioners must have a minimum of five years' experience in law enforcement, and at least one must be a certified public accountant. No more than three commissioners can be members of the same political party. Although the lottery act states that a five-person commission is responsible for administering the lottery, with the exception of the three months between October and December 1994, the lottery has operated with a commission of only four members since December 15, 1993.

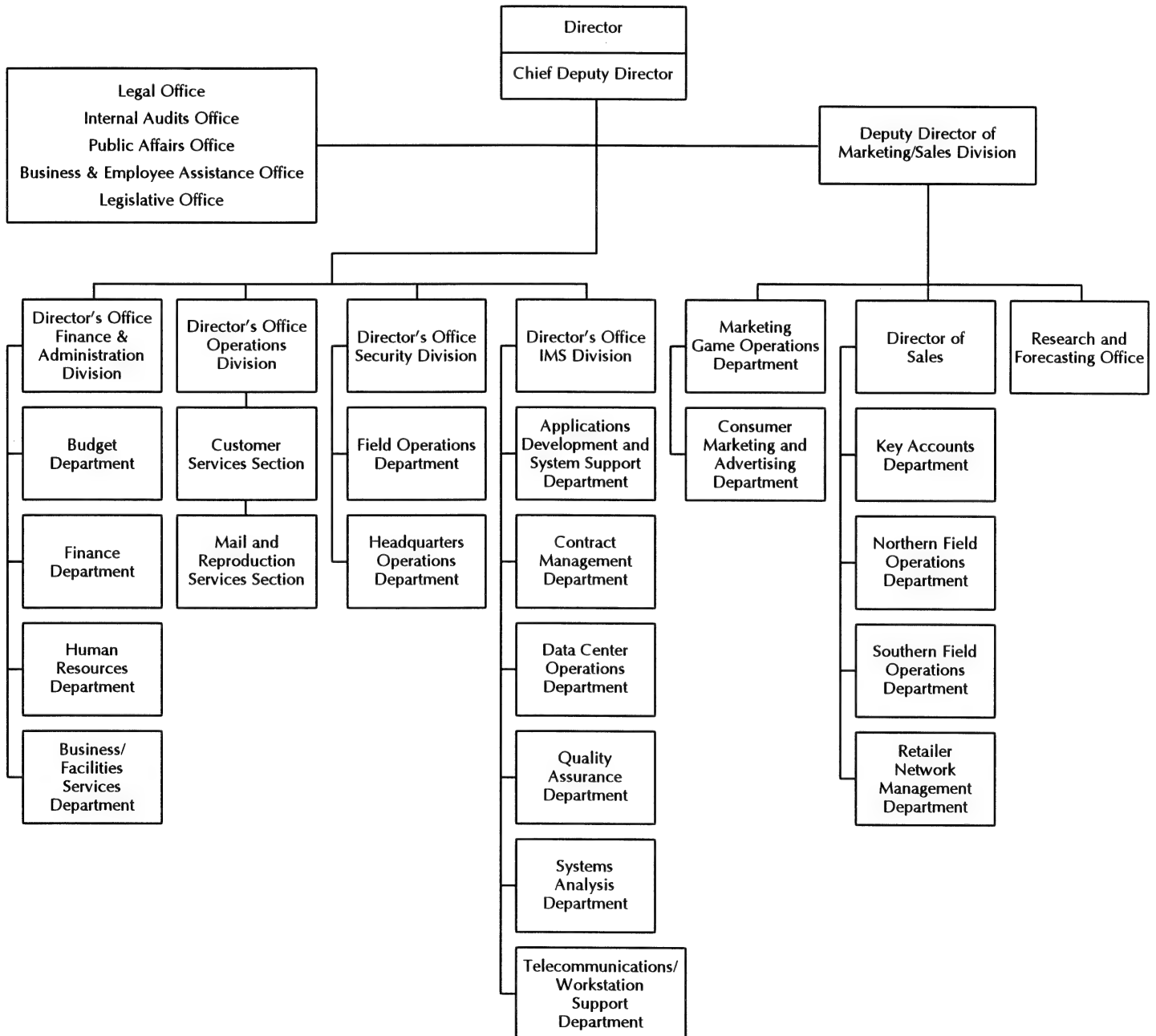
The commission has final approval in setting policy direction within the constraints of the lottery act and must consider the particularly sensitive nature of the lottery in all its decisions. Commissioners meet monthly to approve game rules and the way prizes are paid, to approve major contract awards, and to decide critical policy issues.

The lottery is organized into an executive division and five operating divisions. The executive division consists of the interim director, chief deputy director, and five offices: Legal; Internal Audits; Public Affairs; Business and Employee Assistance; and Legislative Liaison. The director supervises and administers the operation of the lottery in accordance with the lottery act and the rules and regulations promulgated by the

commission. The current interim director was appointed on June 12, 1996. Figure 1 shows the lottery organization as of June 1996.

Figure 1

***The Organization of the
California State Lottery
as of June 1996***



The Lottery's Games

The lottery sells two basic types of products, on-line games and instant ticket games. During fiscal year 1995-96, the lottery ran five on-line games: a daily three-digit numbers game (Daily 3), a six-times weekly four-digit card game (Decco), a 5/39 lotto game (Fantasy 5) with five draws per week, a twice-weekly 6/51 lotto game (SuperLotto), and Keno, with draws every five minutes. In the on-line games, players can select their own numbers and enter them into the terminal using an optical mark reader play slip. The retailer can also enter the numbers manually. If players do not wish to make their own selections, the computer system will generate numbers using a random number generator at the on-line terminal and produce the ticket, called a "quick pick." Approximately 13,000 retailers offer the on-line games; these retailers may also sell the instant ticket games.

In the on-line games, all tickets are potential winners until the lottery conducts the respective drawings for the games. In the SuperLotto game, the jackpot prize amount accumulates until someone wins by matching all six winning numbers. When the prize amount reaches \$20 million, the lottery experiences larger sales; this period is called "lotto fever."

The other type of lottery product, the Scratcher ticket, is commonly known as an instant ticket game. Scratcher tickets are aluminum foil-based or recyclable bulk paper with a latex-coated scratch-off section. The player scratches off the latex to find out whether the ticket is a winner. The lottery designs its Scratcher games around a variety of themes and offers different prize structures. During fiscal year 1995-96, the lottery introduced 24 new Scratcher ticket games and had over 20 different games running at any one time. Approximately 9,000 retailers sell the Scratcher tickets only; they do not sell the on-line games.

Scratcher Automation

Nationwide, 23 of the 37 state lotteries have a system in place to automatically validate winning instant tickets. California is currently implementing its Scratcher automation project. When fully implemented, Scratcher automation will allow all retailers to automatically validate any Scratcher ticket through an on-line terminal or instant ticket validation machine, and be reimbursed for payment of any prize less than \$600, regardless of where the customer purchased the winning ticket.

To provide Scratcher validation capability to its high-volume retailers, the lottery will add bar code readers to the clerk activated on-line terminals currently in use. The lottery will install what it calls LINK terminals at new retailer locations and at existing retailer locations that do not currently sell the on-line games. The LINK terminals will perform all on-line game transactions as well as Scratcher validation. For retailers that sell only Scratcher tickets, the lottery will install validation terminals that will only perform Scratcher validation transactions.

Currently, the lottery discounts the cost of Scratcher ticket packs to its retailers in order to reimburse the retailers for the low-tier and free ticket prizes that the retailers pay to winning customers. When the Scratcher automation project is complete, the lottery will no longer discount the price the retailers pay for Scratcher tickets for the prizes paid by the retailer. This is because the Scratcher validation system will provide a process for the lottery to reimburse retailers for paying any prizes less than \$600. In addition, the system will provide periodic reports for the retailers.

Total sales generated from lottery games during fiscal year 1995-96 were nearly \$2.3 billion. Figure 2 shows the distribution of revenues by on-line games and Scratcher tickets for the fiscal year.

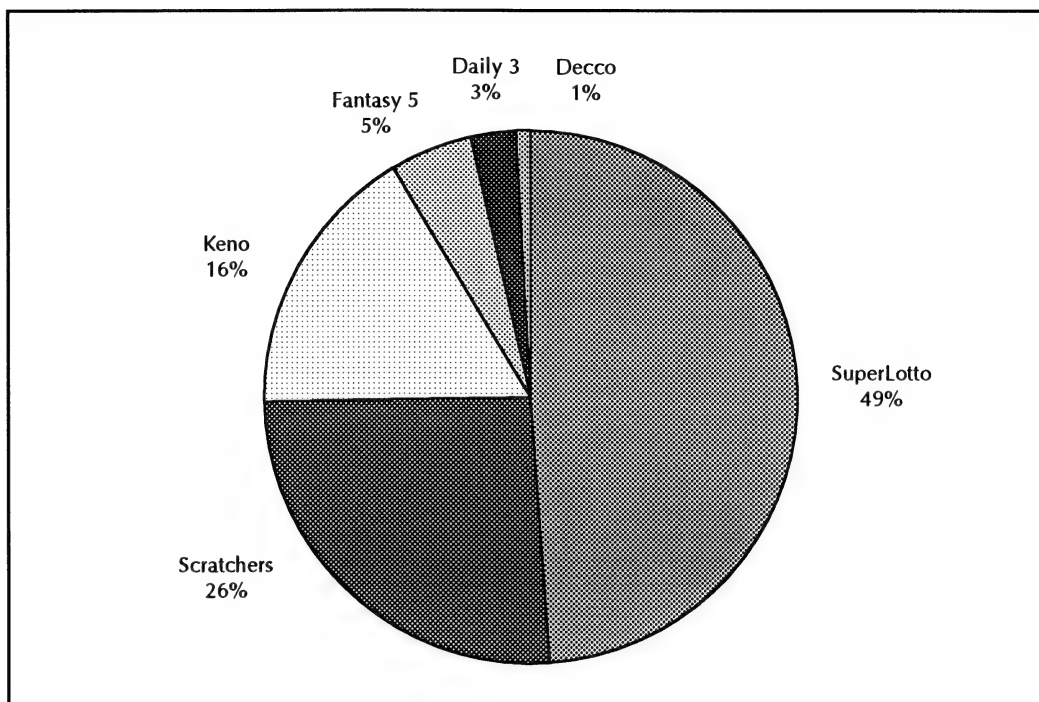
Statutory Requirements

The lottery act stipulates how the lottery's revenues are to be allocated. Fifty percent of the total annual revenues must be returned to the public as prizes and at least 34 percent must be allocated to public education, in addition to all unclaimed prize money and interest earned on funds held in the State Lottery Fund. No more than 16 percent of the total annual revenues can be allocated for the payment of expenses of the lottery. To the extent that expenses of the lottery are less than 16 percent of the total annual revenues, any surplus funds must also be allocated to public education.

The lottery act stipulates that certain audits and reviews will be performed periodically. Each year the lottery is required to have an audit of all its accounts and transactions performed by an independent firm of certified public accountants. The audited financial statements must be presented to the commission, the governor, the state controller, the treasurer, the state attorney general, and the Legislature not more than 120 days after the close of the fiscal year.

Figure 2

***Percentage of Lottery Revenues by Game
Fiscal Year 1995-96***



Note: Based on unofficial revenue numbers for fiscal year 1995-96.

Every two years, the lottery must engage an independent firm experienced in security procedures to conduct a comprehensive review of all aspects of security in the operation of the lottery. The portion of the report containing the overall evaluation of the lottery in terms of each aspect of security must be presented to the commission, the governor, the state controller, the treasurer, the state attorney general, and the Legislature. The portion of this report containing specific recommendations has a more limited distribution.

Periodically, but at no specified interval, the lottery director must engage independent firms to conduct demographic studies of lottery players and studies of the effectiveness of lottery communications. In addition, the lottery act requires the state controller to conduct quarterly and annual post-audits of all accounts and transactions of the lottery and other special post-audits as the state controller deems necessary.

The lottery act also imposes limitations on the types of lottery games that may be offered. For example, no lottery game may use the theme of bingo, roulette, dice, baccarat, blackjack,

Lucky 7's, draw poker, slot machines, or dog racing. In addition, in lottery games utilizing tickets, each ticket must bear a unique number distinguishing it from every other ticket in that game. Finally, in games utilizing computer terminals or other devices, no coins or currency shall be dispensed to players from such computer terminals or devices.

Recent Events Reducing Future Revenues

On June 24, 1996, the Supreme Court of California ruled the lottery's Keno game illegal because it is a banking game. Specifically, each participant bets against the lottery for a fixed payoff of up to \$250,000, depending on how many numbers were played and how many were matched. The lottery immediately suspended the game when the ruling was announced. In addition, on July 3, 1996, the state attorney general opined that the lottery's Scratcher vending machines were an illegal method of distributing Scratcher tickets. The lottery immediately apprised its retailers to stop using the machines. The state attorney general is currently reviewing the legality of the lottery's remaining games.

Based on preliminary totals for fiscal year 1995-96, the Keno game generated revenues of about \$378 million, or 16.5 percent of total revenues. The Scratcher vending machine retailers accounted for approximately \$200 million or 8.7 percent of the lottery's total revenues. As a result of these rulings, the lottery is estimating revenues for fiscal year 1996-97 to be approximately \$1.9 billion, a reduction of about \$500 million or 22 percent.

Scope and Methodology

The purpose of this audit was to perform a comprehensive performance audit of the lottery's operations with emphasis on the areas in which the lottery can be more efficient and effective. Specifically, we were asked to review the following areas:

- The lottery's process for maintaining an up-to-date strategic plan;
- Benchmarks the lottery uses to measure its performance and corrective action taken based on this evaluation;

- The efficiency and effectiveness of the lottery's management systems and organizational structure;
- All audit activity mandated by the lottery act for unnecessary duplication and whether the costs and benefits of these audits provide value to the State and to the general public;
- The lottery's methods of operation, types of budgetary and legislative oversight, types of gaming offered, administrative costs, staffing, sales levels and trends, and other relevant benchmarks, compared to other lotteries throughout the United States; and
- The lottery's use of information technology. The results of this work will be discussed in a separate report issued at a later date.

To determine whether the lottery's strategic planning process was current, we traced selected elements of the fiscal year 1996-97 annual business plan to the divisional plans prepared by the individual divisions. We also identified the performance measures or benchmarks established by the lottery in its planning process and determined whether these performance measures provide an adequate assessment of the lottery's progress toward meeting its goals and objectives. Further, we identified those elements of a long-term plan that are not a part of the lottery's vision statements and analyzed whether the elements could be an effective part of a long-term plan for the lottery. In addition, we determined whether other state lotteries have developed strategic plans.

To determine the effectiveness and efficiency of the lottery's operations, we reviewed the following areas:

- Staffing levels;
- Administrative activities and expenses;
- Marketing and sales methodologies;
- Procurement and contracting policies;
- Claims processing; and
- Fiscal controls and reporting.

We compared lottery staffing by division for the past five fiscal years and reviewed the rationale for the lottery's fiscal year 1994-95 reorganization, including whether reassignments were reasonable. We determined the elements that comprise the lottery's administrative costs, traced them to supporting documentation, and analyzed whether the costs are a necessary and effective use of the lottery's resources. We also compared the elements of administrative costs to those reported to us by eight other state lotteries.

We analyzed the effectiveness of the Sales Division, particularly related to staffing levels and responsibilities of the district sales representatives (DSRs) and telemarketing representatives (telemarketers). As part of this review, we identified possible duplications of effort and more effective methods of enhancing sales and distributing tickets to retailers. We also analyzed the incentive programs available to DSRs and telemarketers to determine if the cost is providing an added benefit to the lottery. We engaged the services of a marketing consultant to assist us in our analysis of the lottery's operations. Further, we followed up on findings reported by the lottery's Internal Audits Office in audits of District Office operations to assess the implementation of corrective action based on its findings.

We also compared the lottery's contracting and procurement policies to the State's Procurement Act and tested the lottery's compliance with its own policies. Because the settlement of the litigation surrounding the lottery's contract with High Integrity Systems, Inc. was not finalized during the period of our fieldwork, this contract was not included in the scope of our audit.

To assess the value provided by audit activity mandated by the lottery act, we reviewed the audit activities of the past two fiscal years and the supporting work products. We also evaluated the timeliness of the reports and which audit recommendations were implemented by the lottery.

To determine how the lottery's operations compare to other state lotteries, we obtained information from industry publications, analyzed responses to surveys sent out by the State Controller's Office and the lottery, and sent additional questionnaires to ten states. We analyzed this information to identify differences between California's lottery operations and those in other states and to determine reasons for the differences.

Chapter 1

The California State Lottery Can Improve Its Strategic Planning Process

Chapter Summary


During its first eight years of operations, the California State Lottery (lottery) focused its strategic planning efforts on short-term problem solving rather than long-term strategic plans. During this period, its annual business plans were marketing plans that covered the products, promotions, and distribution of its lottery games. In 1993, the lottery began developing a strategic planning process that it has continued to change and improve. Although the lottery has significantly improved its annual business planning process over the years, it needs to make additional improvements to maximize the usefulness of its annual business plan.

The lottery's fiscal year 1996-97 comprehensive annual business plan is a two-part document consisting of a corporate plan and a divisional management plan that supplements the corporate plan. However, the segregation of the plan into two parts leads to inconsistencies between the parts. Moreover, the organizational objectives documented within the plan are not clearly prioritized and appear to be incomplete. Additionally, the lottery has not fully developed benchmarks to evaluate its performance and measure the attainment of its goals and objectives. Further, some of the lottery's divisional plans did not address the resource requirements for the planned activities for some projects.


Although the lottery has been in operation for over ten years, it has not developed an adequate long-term strategic plan. Rather, the lottery has limited its long-term planning to a five-year vision document that it created during fiscal year 1993-94. The vision document lays the groundwork for developing the lottery's long-term goals and objectives but does not include the elements necessary to provide a path to reach those goals and objectives.

***Evolution of the Lottery's Strategic
Planning Process Has Resulted
in a More Comprehensive
Annual Business Plan***

The lottery has significantly changed its annual business planning process in recent years and moved from a sales-oriented annual business plan to one that incorporates activities of all its operating divisions. An organization's annual business plan should include the short-term goals, objectives, and strategies needed to implement the goals, objectives, and strategies delineated in its long-term strategic plan. Unlike a long-term strategic plan, an annual business plan describes in detail the activities necessary to accomplish the organization's goals and objectives.



The lottery has moved from a sales-oriented annual business plan to one that incorporates activities of all its operating divisions.



Prior to 1993, the lottery's annual business plans were developed by the Marketing Division with little input from other divisions. Consequently, the plans focused mostly on the marketing and sales of the lottery's products. After progressing through its first eight years of operations, the lottery's management recognized the need to develop a comprehensive strategic planning process that would enable it to successfully move forward. As a result, during fiscal year 1993-94 the lottery developed a long-term vision document and a two-year operational plan.

The long-term vision document, "Vision 1999," broadly identifies the principles under which the lottery operates and describes where it expects to be in the year 1999. However, the vision document does not provide any specific goals or objectives that the lottery must meet to achieve success and, therefore, does not provide the guidance needed to adequately direct future operations and guide development of effective annual business plans.


The two-year operational plan addressed the components of the lottery's internal operations. The lottery used data gathered by an external accounting firm and input from its own staff to develop the operational plan that covered the two-year period between 1994 and 1996. The two-year operational plan specifically defined the corporate vision and mission, identified the lottery's weaknesses, and established action plans to improve those weaknesses. However, the plan did not include specific sales goals for the lottery. Sales goals for fiscal years 1994-95 and 1995-96 were identified in annual business plans that were developed by the Marketing and Sales divisions for each of the respective years.

As stated in its two-year operational plan, the mission of the lottery is "to maximize the revenues generated for public education through the sale of lottery tickets." The mission statement also identifies the lottery's guiding principles for accomplishing its mission as the following:


- Exemplary customer service to those who buy or sell its products;
- A working environment that encourages, supports, and recognizes contributions of its employees;
- Efficiency and effectiveness in all operations; and
- Accountability, fairness, and integrity throughout the organization that instills public trust.

The two-year operational plan included 24 projects that were focused in four key areas. These key areas are improved planning and coordination, effective use of resources, improved staff support, and accountability. According to the lottery's business planning manager, by July 1995 all projects had been implemented or integrated into ongoing activities.

As a result of the two-year operational plan, the lottery made additional modifications to its planning process that included creating a business planning committee, made up of division directors, to oversee the development of its annual plans. During 1995, the lottery decided to further revise its previous planning process and create an annual business plan that was more comprehensive. Under the new planning process, effective for the fiscal year 1996-97 annual plan, each division performs its own business review. The business review documents the lottery's analysis of industry trends, marketing program results, and implications for action based on data collected related to activities from the prior six-month period. The divisions provide their business reviews to the business planning committee for the development of the Annual Business Plan, which we refer to as the corporate plan.



The new two-part annual plan includes a corporate Annual Business Plan and a divisional Management Plan.



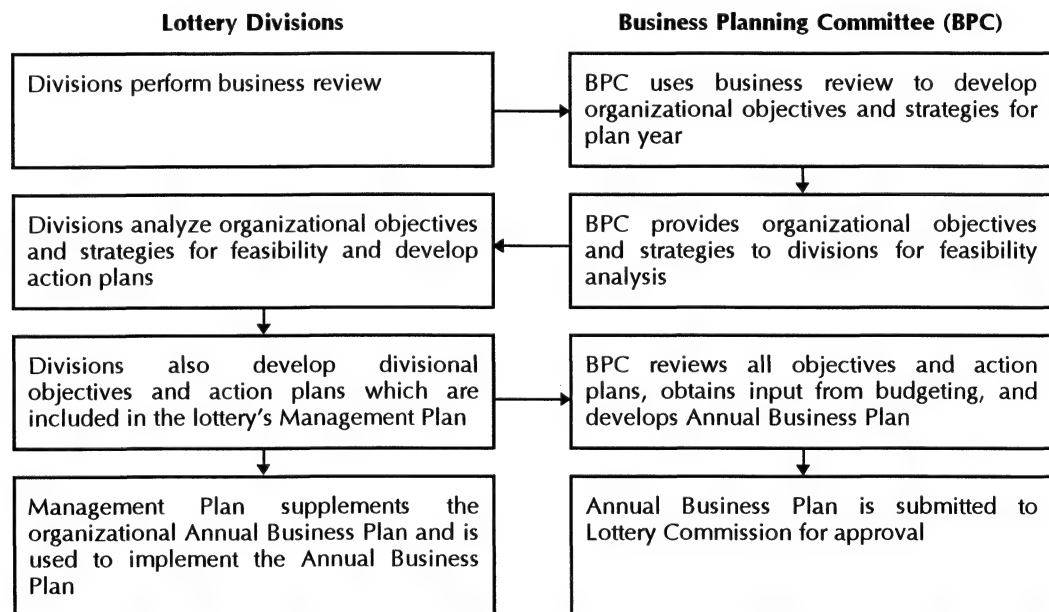
The corporate plan describes the organizational objectives and the strategies necessary to achieve those objectives. Divisional management then develops action plans for the organizational objectives, as well as its own additional objectives, and documents them in its annual Management Plan, which we refer to as the divisional plan. This divisional plan supplements the corporate plan and describes more specifically how the organizational objectives will be carried out at the division level. The corporate plan and the divisional plan together form

the lottery's comprehensive annual business plan for fiscal year 1996-97. Appendix A shows a summary of the evolution of the lottery's strategic planning process.

This revised annual planning process allows lottery management to keep abreast of departmental issues that could affect the use of resources and could ultimately impact corporate goals. The new format provides the lottery with a more realistic annual business plan because goals and objectives are being set at the divisional level. Consequently, the fiscal year 1996-97 comprehensive annual business plan includes much more detail than was documented in the prior year annual plan. For example, we found that most of the planned activities were more clearly described than they had been in the past and objectives were geared more toward outcomes rather than outputs. Figure 3 shows the planning process used to develop the fiscal year 1996-97 Annual Business Plan.

Figure 3


***Planning Process for Development of
Fiscal Year 1996-97 Annual Business Plan***



The Lottery Needs To Further Improve Its Annual Business Planning Process

Although the lottery has substantially improved its annual business planning process, there are further refinements that the lottery can make to its annual business plans to make them more useful.

Inconsistencies Exist Between the Corporate Plan and the Divisional Plan


*The comprehensive
annual plan's two-part
approach causes some
deficiencies:*


- ✓ *Goals in the two plans
sometimes differ.*
- ✓ *Some information is
inconsistent.*
- ✓ *The divisional plan did
not address actions
required by corporate
plan goals.*

The segregation of the fiscal year 1996-97 comprehensive annual business plan into two parts, the corporate plan and the divisional plan, causes some deficiencies in that the divisional goals sometimes differ from the organizational goals. Additionally, the source of information used in formulating the action plans is not always annotated in either the divisional plan or the corporate plan itself. Consequently, it is sometimes difficult to evaluate the reasonableness of some of the actions formulated to achieve the objectives because the supporting data, or references to where the support can be found, are not included in the plan.


Further, information in the corporate plan and the divisional plan is inconsistent. For example, the corporate plan quantifies the sales goal for the SuperLotto game as \$1.08 billion for fiscal year 1996-97 in one section but uses a targeted objective of \$1.09 billion in another section. The divisional plan uses a target of \$1.1 billion. Additionally, one of the divisional plan's tactics for marketing the SuperLotto game is to conduct SuperLotto promotions in the second and fourth quarters of the fiscal year, but in another section the supporting program action plans and promotion timeline reflect that the promotions will be conducted during the first and fourth quarters. In another example, the corporate plan objective for the Scratcher game is to increase sales by 15 percent for a goal of \$690 million while the divisional plan sets the targeted objective at an increase of 20 percent for a goal of \$725 million. According to the lottery's business planning manager, the corporate sales goals are the lottery's official goals, and differences between the plans are mistakes.

We also identified instances where the divisional plan did not address actions required by corporate goals. For example, one of the organizational objectives and its related strategy calls for expanding a customer call center (project). The Corporate Objectives section of the divisional plan includes a general

action plan that identifies the Information Management Services (IMS) Division's responsibilities related to the equipment and technological requirements of this project. However, the IMS Division's section of the divisional plan does not address the project at all. In contrast, we found a detailed action plan documenting the personnel and workload requirements related to the project in the Operations Division's section of the divisional plan. Neither of the action plans address the communication or coordination effort that we would expect to find when more than one division has responsibility for implementing a strategy and its related project.



The two-part comprehensive annual plan does not provide the clarity that a single-document plan would provide.




Although the organizational goals and objectives represent the lottery's key priorities, discrepancies within and between the two documents make the lottery's ultimate goals, objectives, and strategies unclear. Once the organizational objectives are communicated to division managers, one plan should then be developed which incorporates them into the individual divisional objectives. A plan consisting of a single document is much more efficient for several reasons. Discrepancies between organizational and divisional objectives and strategies are eliminated, the ultimate entity objectives for the fiscal year are clear, and the plan is better coordinated and easier for readers and users of the plan to follow. A summary document could then be prepared, for external use, which highlights the approved objectives and related strategies.


For strategies or planned activities that are based on an analysis of prior period supporting data or assumptions that are not addressed in the comprehensive annual business plan itself, the plan should include a reference to that supporting data. This would enable readers of the plan, and users of the plan who are responsible for implementing the strategies, to more easily understand their development. For example, readers of the annual plan include non-managerial lottery staff, California State Lottery Commission members, and other interested parties, who may not be familiar with the lottery's activities and operations or information from its past years' business reviews.

***Priorities of Organizational
Objectives in the Corporate Plan
Are Inadequate***

Organizational objectives identified in the lottery's corporate plan appear to be incomplete or unreasonable in some areas. We noted that none of the lottery's organizational objectives specifically address SuperLotto, its largest-selling game. In addition, the priority that the lottery gives to each of the



None of the lottery's organizational objectives specifically address SuperLotto, its largest-selling game.



individual objectives is unclear. Successful planning requires prioritization of organizational goals, objectives, and strategies. Significant implications for action, which the lottery has identified through the monitoring of its business environment and industry trends, should be incorporated into its organizational objectives.

The lottery's fiscal year 1996-97 corporate plan identifies the first and second of eight broad organizational objectives as 'Building Sales' and 'Games for Social Trade Styles.' However, none of the individual objectives under these two categories address SuperLotto sales, which has consistently dominated annual sales since fiscal year 1987-88 and is estimated to generate 54 percent of total sales for fiscal year 1996-97 under its budget contingency plan. Rather, the lottery is giving priority to the development of a new on-line game. Because of other projects the lottery is implementing and the suspension of Keno, this new game cannot be introduced until fiscal year 1997-98. Although we can assume that some of the individual corporate objectives under the third category 'Improve Performance in Key Trade Channels,' should enable the lottery to maintain or increase all lottery game sales, the specific effect on SuperLotto sales is not addressed. Even if the lottery was not planning to make significant changes to SuperLotto in fiscal year 1996-97, we would expect that one of the organizational objectives would be to maintain playership for the game. In contrast, maintaining SuperLotto playership was listed as the first strategic priority in the fiscal year 1995-96 Annual Business Plan.


In addition, neither the corporate plan nor the divisional plan address an intent to pursue legislative changes. During our analysis of the corporate and divisional plans, we reviewed the implications for action indicated in previous business reviews to determine which activities directly tied into the objectives, strategies, and planned activities for fiscal year 1996-97. Some of the planned activities for fiscal year 1996-97 were supported by implications for action documented in previous business reviews. However, both of the Marketing Division's last two business reviews document the success that other states have had with bingo-theme instant games. Specifically, the current business review states that in 14 of 37 state lotteries, bingo-theme games had the top weekly sales volume. Additionally, a 1994 business review documents that one of the implications for action is to "continue to pursue legislative changes on bingo as these games remain the best selling even after 1 to 2 years in existence." Furthermore, the prior year review section of the corporate plan documents that industry data for instant, Scratcher-type games reflect that California is among the lowest in weekly per capita sales. According to a

1995 business review, bingo-theme instant games were allowed in three of the states with per capita sales double that of California.


The lottery act currently prohibits bingo and certain other theme games, so the lottery would need to seek legislation to amend the lottery act. Because the lottery had developed contingency plans anticipating the loss of the Keno game, we would expect to have found the issue of planning for lottery act changes and bingo-theme games addressed as one of the fiscal year 1996-97 objectives. According to the lottery's business planning manager, the lottery has no immediate plans to attempt to eliminate this barrier and discuss the issue with the Legislature, but are currently waiting for further clarification on the range of allowable lottery games. If the lottery has determined that it cannot obtain approval for bingo-theme games, then it should reduce the time it spends analyzing data related to this issue and use its resources elsewhere.

The Lottery Does Not Fully Utilize Benchmarks



Benchmarking is a process whereby performance measures, or benchmarks, are used to evaluate the effectiveness and efficiency of an entity's planned activities. This enables the entity to measure the progress it has made in implementing its planned strategies and achieving its objectives and goals. Benchmarks can be output measures of the quantity of a good or service produced over a specified time period or outcome measures which quantify or qualify the results of services provided. Efficiency indicators, such as productivity measures and unit cost, can also be used as benchmarks.



Benchmarks are the performance measures used to evaluate the effectiveness and efficiency of planned activities.



The lottery sometimes uses benchmarks and targets effectively. For example, the action plan for the SuperLotto Match 3 of 6 program specifies the expected goals for incremental sales, increased playership, and player awareness during each of two promotions. The lottery's decision to run these promotions was based on its analysis of the success of similar-type promotions in prior years. During these various promotions, SuperLotto players who matched 3 of 6 numbers were entered into a special drawing for a chance to win additional cash prizes, airline tickets, or cruises. The lottery established targeted sales goals and measured them against actual sales results to determine the success of each of the various promotions. Based on the results of this measurement process, the lottery decided to modify and focus on cash prize promotions for fiscal year 1996-97.



Sales objectives do not address expected outcomes or results to be achieved from the related planned activities.


However, the lottery did not always establish targets or benchmarks in the fiscal year 1996-97 comprehensive annual business plan. Strategies that support sales objectives for each game category did not address the expected outcome or output from the related planned activities. Similarly, action plans for individual Scratcher games are not results-oriented in that planned activities do not focus on the expected outcomes and outputs. Instead, the only target the lottery sets is the overall Scratcher game sales goal. According to the game operations department manager (game manager), the lottery does not establish targets for incremental sales of each individual Scratcher game as it is difficult to isolate and precisely quantify what drives an overall increase in Scratcher sales during a period, since many programs impacting sales occur simultaneously. Further, the game manager stated that consideration is given to the entire product category when major games or marketing initiatives are taking place. For example, the lottery had specific targets for the introduction of \$2 Scratcher games and the launch of "Weekly Grand," a special game with a unique prize structure and advertising to kick it off. Consequently, we would expect to find sales targets for some of the lottery's product plans for fiscal year 1996-97, such as boosting payouts on \$2 games, launching a continuous "Happy Birthday" Scratcher game, and promoting a "Star Trek" Scratcher theme game. However, the plan did not identify any sales targets for these Scratcher product categories.


As another example, the organizational objective which supports increasing sales in key trade channels is to "Increase sales in 1,000 supermarkets by at least 15 percent." However, neither the corporate nor the divisional plan addresses any specific expectations, or benchmarks, directly related to the SuperLotto game or any other individual game. In addition, other organizational objectives, such as improving performance in malls and gas stations, do not address any expected overall or individual sales results from these activities. By not establishing benchmarks for game categories, the lottery cannot adequately evaluate its performance by category, measure its success, and implement changes to particular products accordingly.

Irrespective of the differences between the corporate and divisional plans, the Marketing Division's objective for the Scratcher game is to increase sales by 15 percent and meet an annual sales goal of \$690 million. Specific strategies include removing purchase barriers by communicating the retailer's cross-cashing of prize ticket capabilities of the Scratcher automation project, implementing product enhancements to all \$2 games, reducing the shelf life for new games, and maximizing perceptions of game variety by introducing unique themes and playstyles. However, specific product plan tactics,

such as increasing total Scratch games from 24 to 30 and increasing the number of \$2 games from 4 to 6 games per year, do not identify the expected results from these planned activities. In addition, the plans do not address what percentage of the total Scratch sales increase is expected to come from automation, the additional \$2 games, or the new game themes. If the Scratch automation project is unexpectedly postponed, the lottery needs to know the effect this would have on its sales goals. Although the lottery continually analyzes product and promotion results, we would expect either the corporate plan or the divisional plan to include some indication of the benchmarks being used to perform that analysis. If a benchmark, such as a dollar sales goal or sales percent increase, was established for the first quarter's activities and the results greatly exceeded or fell below that goal, then the lottery could make adjustments to similar activities in future quarters.



The lottery should use benchmarks to determine if it is achieving the desired results, and make adjustments as necessary.




Without established benchmarks for general goals that are divided into various segments, the lottery has no way to measure the success of the related activities or track its results. Additionally, documenting targets for each segment of planned activities within a game category provides a basis to determine the importance of each strategy in meeting the sales category objective. Performance measures should be established for planned activities, as appropriate, and be adequate to determine the outcome of implemented activities and progress of goal attainment. Benchmarks and planned activities can then be revised as necessary upon evaluating prior period outcomes.


The divisional plan includes a reference to a fiscal year 1996-97 Annual Business Plan Tracking System that will be used to monitor the progress of implementing both organizational and divisional objectives. Under this system, the division directors began providing monthly status reports on their respective organizational and divisional objectives to the business planning committee as of August 1, 1996. In addition, the division directors will provide quarterly reports on the status of organizational objectives to the commission starting in October 1996. We were not able to review the initial monthly reports to determine whether this new tracking system has been implemented because the first reports were not available before completion of our fieldwork for this audit.

Some Divisional Plans Did Not Address the Use of Resources

We found that some divisions did not always specify the resource requirements for their planned activities. The development of all action plans should include an analysis of the costs and benefits related to the planned activities. Documentation of the results of this analysis should be included within that action plan.



The development of all action plans should include an analysis of costs and benefits related to the planned activities.



One of the organizational objectives is to improve customer service provided to players, retailers, and the general public through the implementation of an expanded call center. The action plan found in the Corporate Objectives section of the divisional plan includes planned activities for the IMS Division, such as defining computer requirements and installing new equipment, but it does not address the resources required for staffing or equipment purchases directly related to these activities. The Operations Division action plan does indicate that a resource assessment will be performed in mid-year (December 1996) related to the project. However, both action plans indicate that activities requiring resources were scheduled to begin in July 1996.

According to the director of the lottery's Customer Service Division (formerly the Operations Division), a cost-benefit analysis for this project has not yet been prepared and, therefore, the lottery cannot currently identify the estimated cost savings that it expects will result from implementation of the call center. The director further stated that implementation of the project was based on the lottery's desire to improve the efficiency of customer service functions, which is difficult to quantify in dollars and cents. The director also stated that the initial training of customer service representatives will be done in-house, using existing staff to fill positions and, therefore, there will be no effect on additional resources. Finally, the director indicated that a study is being performed that will include a cost-savings analysis. The study will be completed prior to implementation of the call center. Although the plan does not require an initial use of additional resources, the use of existing staff and supplies for training and filling positions will utilize resources that could have been allocated to other projects.

One of the objectives of the Finance and Administration Division is to implement a 'California State Lottery Accounting University' program to develop and implement training, during the fiscal year that will enable lottery staff and some external groups to understand the lottery's unique financial operations.

Planned activities include developing class modules, providing training, and evaluating the training. These activities will require resources to purchase materials; pay for the staffing costs to develop, train, and evaluate the program; and cover the loss of lottery staff hours for those who receive the training. However, the plan indicates that the resource requirements are 'none.'

The Lottery Needs To Develop a Long-Term Strategic Plan

—◆—
*The lottery's "Vision
1999" document does not
contain all the elements
necessary for an adequate
long-term strategic plan.*
—◆—

Although the lottery has been in operation for more than ten years, it has not developed an adequate long-term strategic plan. The lottery has limited its long-term planning to its "Vision 1999" document that it prepared during fiscal year 1993-94. However, it only alludes to the organization's long-term goals by vaguely addressing expected accomplishments. The document does not provide any specific objectives that the lottery must meet in order to achieve its long-term goals and, therefore, does not provide the guidance necessary to develop effective annual business plans.

Unlike a strategic plan, the "Vision 1999" document does not formulate objectives to meet the lottery's mission or clearly identify its strengths, weaknesses, problems, and opportunities. Additionally, the document does not chart a path between the lottery's present and long-term vision by establishing quantitative goals, timelines, or action plans that tie short-term activities and goals into long-term strategies. Without the quantitative goals established in a strategic plan, the lottery has no means by which to measure its progress in achieving its annual goals in relation to its long-term goals. The document merely lays the groundwork for developing the lottery's long-term goals, objectives, and strategies.

Strategic planning is a long-term, future-oriented process of assessment, goal setting, and decision-making that charts a path between an organization's present condition and its vision of the future. Establishing and documenting long-term strategies, goals, and objectives are a necessary part of successful planning in any business environment. To develop its long-term strategic plan, an organization needs to identify its mission, which states the reason for the organization's existence and defines its basic values and philosophies. From this mission, it can formulate its activities and establish its goals. Goals should be well-defined and prioritized, objectives should be set to provide clear targets for specific action, strategies should be formulated from goals and objectives and describe the methods by which they will be

achieved, and action plans should detail how a strategy will be implemented. Strategic planning should include an evaluation of an organization's strengths, weaknesses, problems, and opportunities, taking into consideration both the internal and external policy environment.

Long-term strategic planning provides an organization's divisional management with direction in developing its annual business plan by providing the information necessary to assist managers in making resource allocation decisions. Additionally, a strategic plan establishes a basis for measuring short-term performance and enables managers to gauge progress, verify goal attainment, and tie short-term activities into long-term goals and objectives. Finally, long-term plans should be periodically reviewed and adjusted according to changes in the policy environment or the organization's performance.

According to the lottery's business planning manager, it is difficult for the lottery to develop long-term strategic plans because of the current rapid pace of legal and technological changes in its marketplace. Consequently, the lottery has focused on short-term plans. However, we sent survey questionnaires to ten other state lotteries. Of the eight lotteries that responded to our survey, five indicated that they have developed a strategic plan. Moreover, Florida has developed a five-year strategic plan and Texas has developed a four-year strategic plan.

Conclusion

The lottery needs to improve its annual planning process and develop a long-term strategic plan. During its more than ten years of operations, the lottery's strategic planning process has been dynamic. Similar to a private enterprise, this organization was in a start-up mode for the first several years of its operation, focusing on short-term problem solving rather than long-term strategic plans. After finding its niche, the lottery began developing a strategic planning process that it has continued to change and improve.

The lottery's format for its annual plans has improved significantly with the fiscal year 1996-97 plan. The new planning process results in a comprehensive annual business plan that is much more outcome-oriented than previous annual plans. However, the two-part planning process is inefficient and allows for discrepancies between the corporate and divisional plans.

In addition, some of the plan elements need improvement. The organizational objectives are not clearly prioritized. Although we identified instances where the lottery had used benchmarks to evaluate prior activities, we found that the plan did not document the expected results from the various strategies which supported the overall SuperLotto and Scratcher sales objectives. Additionally, the lottery has not established performance measures for Scratcher games, either by product category or by individual game. As a result, the lottery cannot adequately evaluate the outcome of its activities or use this evaluation in future decision making. Further, we found that action plans for the IMS, Operations, and Finance and Administration Divisions did not address the specific resources that would be used. The resource requirements of all planned activities should be considered in order to develop an effective annual budget.

The lottery is not currently operating under a long-term strategic plan because its management believes that legal and technological changes in its marketplace make it difficult to develop long-term strategies. However, to effectively manage its operations, the lottery should develop a long-term strategic plan and modify it as needed to accommodate the challenges of its ever-changing business environment. The long-term strategic plan should clearly describe management's goals and objectives, and the methods by which it plans on achieving these goals. Without a long-term strategic plan, the lottery does not have a mechanism by which it can direct and measure the success of its short-term activities and its success in accomplishing its overall mission.

Recommendations

To further improve its annual business plan, the lottery should:

- Develop a comprehensive plan that more fully integrates the organizational objectives with the divisional objectives and action plans into a single document ensuring that all discrepancies between organizational and divisional objectives are eliminated;
- Clearly prioritize the organizational goals and objectives identified within its annual plan ensuring that all significant organizational objectives have been addressed;
- Include a reference to the data or assumptions that support strategies and planned activities within the annual plan itself; and

- Document the communication effort that will take place between divisions when planned activities involve more than one division.

To further expand its use of benchmarks, the lottery should:

- Establish sales targets for individual Scratcher games or Scratcher game product categories, use the benchmarks to evaluate the performance of games or game categories, and implement changes to planned activities accordingly; and
- Document the benchmarks or targets that support the sales goals for major game categories, such as SuperLotto and Scratchers, and use the benchmarks to evaluate performance.

To develop a more effective annual budget, the lottery should ensure that all costs related to each division's planned activities are fully analyzed and considered during the resource allocation process and that any utilization of resources is documented within the respective divisional action plan.

To effectively manage its operations, the lottery should develop an adequate long-term strategic plan and modify it as needed to accommodate changes in its business environment.

Chapter 2

The California State Lottery Needs To Continue To Monitor and Reduce Its Administrative Costs

Chapter Summary

The State Lottery Initiative Constitution Amendment and Statute (lottery act) allows the California State Lottery (lottery) a maximum of 16 percent of total annual revenues for administrative costs, which consist of game costs and operating expenses. For fiscal year 1995-96, the lottery's preliminary administrative costs totaled \$355 million. Although the lottery does not have much discretion over its gaming costs, it could exercise more control over its operating costs. Furthermore, with the recent loss of the Keno game and Scratcher vending machines, it is imperative that the lottery look for opportunities to continue to reduce its administrative costs.



The lottery developed a budget contingency plan for fiscal year 1996-97 that incorporated reduced revenues related to the loss of the Keno game. At the July 26, 1996, commission meeting, lottery staff presented an additional \$6.1 million in administrative expense reductions for the commission's information. However, because of the uncertainty surrounding the legality of the lottery's other games, as well as the inherent uncertainty in sales forecasts, the lottery may be faced with additional shortfalls. Currently, the lottery's budget provides little, if any, buffer for any unforeseen contingencies.

We reviewed information related to lottery operations in other states from both industry publications and responses to surveys sent to those states. We found that merely comparing the lotteries' administrative costs as a percentage of sales is not a reliable benchmark because of underlying factors that impact the calculation. However, when gaming mix and other factors are taken into consideration, California's lottery operations are similar in many respects to those of other state lotteries. Finally, we noted that California has the lowest sales per capita compared to the other states we surveyed.

Using preliminary expense numbers, in fiscal year 1995-96, contracted and professional services were \$8.2 million, or 6 percent, of the lottery's operating costs. The services

provided by the State Controller's Office (SCO) accounted for \$2.3 million of these costs. For the past 11 years, the SCO has performed a variety of services for the lottery, including field audits, electronic data processing audits, and claims processing; the SCO has charged the lottery over \$29 million for these services. However, our review disclosed that communication between the lottery and the SCO related to the amounts the lottery pays for these services can be improved. We also noted that the SCO reports are not always timely and are of limited value to the lottery. Further, some of the planned audit work for fiscal year 1996-97 may duplicate the work of independent contractors that the lottery has hired to perform both the annual financial audit and the biennial security audit.

Background


In fiscal year 1995-96, the lottery's administrative expenses of \$355 million consisted of \$222 million in gaming costs and \$133 million in operating expenses.


Under the provisions of the lottery act, the lottery is allowed no more than 16 percent of total annual revenues for paying the expenses of running the lottery. These administrative expenses consist of game costs, which vary proportionally with changes in sales, and the operating expenses of the lottery. Using preliminary expense numbers, in fiscal year 1995-96, the lottery's administrative expenses totaled \$355 million, of which \$222 million was direct game costs and \$133 million was lottery operating expense.

Game costs consist of commissions and incentive payments made to lottery retailers for carrying the on-line and/or instant ticket games, contract payments made to the lottery's on-line game contractor, and the costs of printing instant tickets. For fiscal year 1995-96, game costs totaled \$222 million and were approximately 9.7 percent of sales, using preliminary expense numbers.

The lottery's operating expenses consist of employee salaries and benefits, advertising costs, sales promotions costs, contracted professional services, and other general and administrative expenses. For fiscal year 1995-96, using preliminary expense numbers, the lottery's operating expenses totaled \$133 million and accounted for approximately 5.8 percent of sales. Table 1 shows the elements of the lottery's administrative costs by gaming costs and operating expenses over the past two fiscal years.

Table 1


***Elements of the Lottery's Administrative Costs
Fiscal Years 1994-95 and 1995-96
(Amounts in Thousands)***

Description	Fiscal Year 1994-95	Percent of Sales	Fiscal Year 1995-96 (Preliminary)	Percent of Sales
Retailer commissions	\$140,896	6.50%	\$148,431	6.47%
Instant direct	13,615	0.63	19,715	0.86
On-line direct	50,180	2.32	54,002	2.35
Total Game Costs	\$204,691	9.45%	\$222,148	9.68%
Salaries and benefits	\$ 43,673	2.02%	\$ 46,189	2.01%
Contracted and professional services	13,166	0.61	8,160	0.36
Advertising, promotion, and public relations	44,655	2.06	60,879	2.65
Amortization and depreciation	13,165	0.61	9,184	0.40
Other general and administrative expenses	16,774	0.77	8,486	0.37
Total Operating Expenses	\$131,433	6.07%	\$132,898	5.79%


Game Costs

Retailer commissions and incentives have been about 6.5 percent of sales over the past two fiscal years. These costs consist of the base retailer commission on all lottery sales, a retailer incentive payment for large winning tickets sold by the retailer, a cashing incentive paid to retailers cashing winning instant tickets in amounts between \$99 and \$599, and other retailer special handling costs.

Although the lottery is not planning to increase the base retailer commission or the cashing incentive, it is planning to add a 2 percent cashing bonus to be paid to retailers cashing winning Scratcher tickets that were not sold by that retailer. The lottery intends this to be an interim measure only during the implementation of the Scratcher automation system to encourage retailer cross-cashing, where retailers pay prizes of winning tickets not purchased at their stores. This incentive would apply only to games for which the retailer paid less than face value for the tickets purchased before the Scratcher automation project was implemented. The lottery expects the cross-cashing element of the Scratcher automation system to begin in December 1996 and estimates that the cross-cashing bonus will be in effect through the end of the fiscal year.



The lottery's on-line gaming costs consist primarily of payments to its contractor who receives 2.895 percent of on-line sales; whereas, instant game costs result primarily from printing Scratchier tickets.



On-line game costs consist primarily of payments made to the on-line game contractor, GTECH Corporation. The contractor receives 2.895 percent of sales from on-line games as its payment for running the games. Telecommunications costs for the telephone lines used to connect the retailers to the central computer system are also included in this element. However, in contrast to some state lotteries, California's lottery charges its retailers for telecommunications and phone lines related to the lottery games, so about 60 percent of the lottery's telecommunications costs are recovered.

Instant game costs are primarily the costs the lottery incurs to print the Scratchier tickets. The lottery uses two Scratchier ticket printers: Scientific Games, Inc. for most of the Scratchier games and Dittler Bros. for special topic, or niche games. Additional instant game costs include ticket deliveries by the lottery's contracted courier, telecommunications costs for the central mid-tier validation system, implementation of the Scratchier automation system, and Scratchier vending machine maintenance, which is performed under contract by GTECH Corporation. Using preliminary expense numbers, in fiscal year 1995-96, instant game costs increased by \$6 million. This increase can be attributed to the payments the lottery has made to High Integrity Systems, Inc. for the implementation of the Scratchier automation project and increased costs for Scratchier tickets because the lottery has increased the number of games it runs.

Because the lottery's game costs are directly related to sales of lottery games and are incurred under contract with various entities, the lottery has little discretion over the level of these expenditures. During fiscal year 1996-97, the lottery will have limited ability to make significant reductions in this area of its administrative costs.

Operating Costs

Over the past two fiscal years, the lottery's operating costs have ranged from 5.8 percent to 6 percent of sales. The lottery's operating costs consist of salaries and benefits, contracted and professional services, advertising, amortization and depreciation, and other administrative expenses. The lottery has more discretion over these costs. In this section, we will discuss the lottery's operating costs in general. Because of its significance, we will discuss specific operating costs related to the lottery's Sales Division in Chapter 3.


The lottery's contracted and professional services include services provided by the SCO for audit and claims processing services, the lottery's security contractor, and independent auditors performing the annual financial audit. Using preliminary expense numbers, the lottery's costs for contract services decreased by \$5 million, or 38 percent, in fiscal year 1995-96 because it no longer needed contracted legal services related to its litigation with High Integrity Systems, Inc.

The greatest portion of the advertising, promotion, and public relations costs relate to contracts with the lottery's three advertising contractors. One of these contracts is for general advertising, one for promotions and point-of-sale services, and one for target market advertising. Using preliminary expense amounts, the lottery's advertising, promotions, and public relations costs increased by \$16 million in fiscal year 1995-96. This was due in part because the lottery resumed advertising for its Scratcher games after a 14-month period of not advertising these games.


Amortization and depreciation costs and other general and administrative expenses can fluctuate for a variety of reasons from year to year.

The Lottery Is Facing Major Reductions in Its Operating Costs

Because it expected the Supreme Court's decision on the legality of the Keno game by the end of fiscal year 1995-96, the lottery developed a budget contingency plan as part of its fiscal year 1996-97 budget. The lottery included in its fiscal year 1996-97 budget the additional demands on its available resources because of retailer compensation issues, cost of living increases, and the implementation of the Scratcher automation project.



The lottery estimates that administrative costs must be reduced by \$30 million to compensate for the loss of Keno.



The lottery's contingency plan assumed that Keno would be declared illegal prior to June 30, 1996, and that the lottery would be prohibited from implementing a replacement monitor game. Using these assumptions, the lottery reduced its sales revenue forecast of \$2.4 billion by \$400 million. As a result of the decrease in sales revenues, the lottery estimated that it would have to reduce its administrative costs by nearly \$30 million. At first it appears that the lottery's estimated impact on the administrative spending budget is understated. Specifically, using the mandatory 16 percent administrative spending cap and applying it to the respective sales forecasts

allows for \$384 million and \$320 million in administrative expenses, respectively. Thus, the anticipated loss in revenues will reduce the lottery's allowable administrative costs by \$64 million, which is \$34 million greater than the \$30 million discussed above. However, the lottery's budget officer explained that \$34 million of the administrative expenses associated with the forecast Keno revenues are "game-related" costs. These costs will be eliminated automatically once Keno no longer generates revenues. Essentially, these costs will disappear without planning or effort on the part of the lottery or the commission.

The remaining \$30 million in administrative spending cuts required more effort and planning on the part of the commission and the lottery, and will require the cooperation of all lottery divisions. The final 1996-97 budget specifically identifies those areas where the lottery made its reductions as shown in Table 2 below.

Table 2


***Budget Reductions
Fiscal Year 1996-97
(In Thousands)***

Description of Cost	Amount
Use current year budget reserve	\$ 8,377
Reduce operating expenses	900
Defer equipment acquisitions and facility improvements	600
Savings from personal services by reducing overtime and temporary help, and implementing hiring freezes	2,500
Discretionary training	400
Advertising	12,880
Broadcasting programs	132
Point of sale	120
Consumer promotions	400
Retailer promotions	440
Postpone new accounting system implementation	3,000
Total	\$29,749


At the July 26, 1996, commission meeting, lottery staff presented an additional \$6.1 million in administrative expense reductions for the commission's information. The \$6.1 million consists of a \$1.1 million reduction in contracts and an additional \$5 million reduction in the lottery's communications budget. The communications budget includes advertising, promotions, and broadcasting costs.

The lottery recognizes that these reductions only maintain its compliance with the 16 percent spending limitation during fiscal year 1996-97 and provide no resources to solve the long-term impact that the elimination of Keno will have on future lottery sales. It contemplates a major restructuring and rebuilding of the lottery organization, which will emphasize sales-building activities.

We agree that these reductions will not be easy ones to make, but we also believe that further reductions may be necessary for the lottery to remain within its mandated administrative cost limit. Although the plan accommodates the loss of Keno revenues and Scratcher vending machine sales, our concern is that it will reduce the lottery's current year budget reserve from almost \$10 million to \$1.5 million. This reduction in the budget reserve will leave the lottery in a vulnerable position with no buffer or reserve to fall back on.



Current budget reductions do not solve the long-term impact that losing Keno will have on future sales. Consequently, the lottery may need to make further reductions to remain within its mandated administrative cost limits.



The uncertainty surrounding the legality of the lottery's other games leaves open the question of how much revenue will be generated during fiscal year 1996-97. In addition, there is always uncertainty in sales forecasts. Given the elimination of the Scratcher vending machines, the delays in the implementation of the Scratcher automation project, and the lottery's planned reduction in advertising, it is likely that the Scratcher revenue forecast of \$590 million may be too optimistic. Further, although the lottery is planning to add games to replace Keno, the implementation dates of these games are tentative. These factors, combined with the inherent uncertainty in forecasted sales figures, make the possibility for other shortfalls likely. As it now stands, the lottery's budget provides little, if any, buffer for these and other unforeseen contingencies. If the lottery does not continue to take aggressive action now to monitor and reduce its administrative spending, it is unlikely that the lottery will be able to remain within its 16 percent administrative expense limit during the upcoming fiscal year.

Comparison of California's Lottery Operations With Other States

We compared the lottery's operations to other lotteries throughout the United States. Specifically, we looked at administrative costs, game mix, prize payouts, retailer commissions, staffing, and strategic planning. California's lottery operations are similar in many respects to those of other states when gaming mix and other factors are taken into consideration.

We obtained information from industry publications, responses to surveys sent out by the SCO and the lottery, and sent additional survey questions to ten states. These states included Arizona, Colorado, Florida, Illinois, Massachusetts, Michigan, Oregon, New York, Texas, and Washington. We received responses to our survey from all states except Oregon and Massachusetts and we gathered relevant information for the California lottery during our review. Our comparative data were based on fiscal year 1994-95, unless stated otherwise.

Comparing only the lottery's administrative costs to those of other states is not a reliable benchmark because of underlying factors and influences.

We found that merely comparing the lottery's administrative cost as a percentage of sales to those of other states is not a reliable benchmark because of underlying factors that impact this calculation. For example, three lotteries have contracted out significant portions of their operations, whereas one lottery is prohibited from contracting out any of its operations. Other underlying factors relate to the types of gaming and thematic restrictions that are imposed on some lotteries which are not imposed on others. This also impacts the lottery's ability to enhance revenue while minimizing its administrative costs. As Table 3 shows, the percentage of revenues generated by game type varies significantly between lotteries.

Table 3

***Percentage of Total Revenues by Game Type
Fiscal Year 1994-95***

	Instant	Numbers	Lotto	Keno	Other
Arizona	27%	-	73%	-	-
California	26	4%	51	19%	-
Colorado	47	-	51	2	-
Florida	26	20	54	-	-
Illinois ¹	36	30	32	-	-
Massachusetts	64	15	10	11	-
Michigan ¹	29	44	23	1	-
New York	22	36	39	3	-
Oregon	4	- ²	3	3	90% ³
Texas	56	5	39	-	-
Washington	30	4	62	4	-


¹The game revenue percentages for these states do not equal 100 percent as their total revenues include additional non-game revenue.

²Revenues generated from numbers games are less than 1 percent of total revenues.


³The majority of Oregon's revenues are generated from Video Lottery Terminals, which are electronic games played on a video screen.

We feel that these inconsistencies, which are not readily apparent, between data provided in some surveys and data provided to industry publications could lead to inaccurate assumptions. Therefore, we believe that, whereas the collection of some statistical data provides a foundation for comparing costs, it may not be possible to isolate the effects of underlying influences.

One segment of the lottery's operations that we believe is critical is prize payouts. We found that California's method of handling prize payouts is similar to those of other states. For example, all eight states surveyed, as well as California, allow their retailers to pay out prizes up to approximately \$600 and each lottery has a unit that processes winning tickets. Further, we noted that the majority of the states surveyed, including California, have laws that regulate the prize payout. For example, California and four other states have statutes which require prize payouts of at least 50 percent. The Illinois lottery has the option of determining its prize payout percentage. Texas has a set prize payout of 50 percent for its Lotto game but it determines the prize payouts for all other games.



Unlike California, a majority of states surveyed have all or a portion of their expenses appropriated by the Legislature.




Our review disclosed that the majority of the states surveyed have all or a portion of their expenses appropriated by the state legislature. Specifically, Illinois has all of its expenses appropriated by the Legislature, whereas Arizona, Florida, Michigan, New York, Colorado, and Washington have their operating costs appropriated but not their gaming costs. In contrast, California and Texas (excluding its Charitable Bingo Division) are the only two states that we surveyed that do not have their expenses appropriated by the state legislature.

However, we learned that Colorado, Texas, and Washington, are allowed to have retained earnings balances which provide an incentive to minimize administrative costs. Specifically, these states had retained earnings balances that range from \$1 million to \$10 million that are not restricted as to use and are available for future operations or distribution. Florida and Illinois are also allowed to have retained earnings; however, their use of retained earnings is restricted to benefiting education, special drawings, or the general fund. In contrast, California, along with Michigan, New York, and Arizona, is not allowed to have retained earnings and as a result, does not have the flexibility of redirecting funds to supplement prize pools or lottery operations. Therefore, the lottery has no incentive to minimize its operating expenses because any unspent administrative funds are not available for future needs.


We compared California's retailer commission of 6 percent to the 36 other lotteries in the United States and found that California's is 0.5 percent to 2 percent higher than 30 of the other lotteries nationwide. However, we also found that when compared geographically, California's retailer commission was similar to two of the four western states we reviewed. Further, from the eight states we surveyed, we gathered information about whether the lotteries were planning to revise the percentages paid for retailer commissions and bonuses in fiscal year 1996-97 and found that four states were not planning to revise retailer commissions and bonuses. However, California, along with Arizona, Colorado, Michigan, and Texas, is considering revising its rate structure. For example, California is implementing a temporary 2 percent cashing bonus incentive when its Scratcher automation project becomes operational. Texas is considering revising its current 5 percent commission based on incremental sales increases and Arizona is considering adjusting its commission structure based on incentives and sales levels. Michigan is considering a tiered commission structure, while Colorado will be increasing its commission by 0.5 percent if its on-line goal is achieved.

Lotteries' Staffing Levels

We obtained statistical information regarding the lotteries' staffing levels. Although California had the highest number of staff at 827, there are several factors that impact the comparison of staffing levels to those of other states. For example, as mentioned earlier, we found that some states have contracted out significant portions of their responsibilities. Specifically, the Texas lottery has contracted out its Sales Division responsibilities to its on-line game contractor, GTECH Corporation. GTECH Corporation has dedicated 155 positions to handle Texas' sales responsibilities. Similarly, the Illinois lottery has contract personnel fill in for sales personnel on an as-needed basis. As a result, the total number of employees as reported in some surveys and industry publications does not reflect the additional staff that provide these contract services. Therefore, a comparison based solely on staffing numbers may not accurately reflect the lotteries' staffing requirements.




Although the lottery's staffing level is higher than other lotteries, several factors may make a comparison solely on numbers misleading.




We also analyzed the lotteries' staffing by division. For example, we asked the lotteries for statistics on the number of their sales representatives. California had the highest number of sales representatives at 184. We found that several other states also had sales representatives that are either in-house or obtained through contract services. For example, the Florida lottery, which offers similar game types, has 147 sales representatives, Texas has 155 contracted sales representatives,

and New York has 107. A factor that may allow California to reduce its sales staff relates to whether the lottery implements the product distribution alternatives that we discuss in detail in Chapter 3. Also, the lottery's implementation of the Scratcher automation project could allow further reductions, thereby making its staffing even more comparable to that of other states.




California has the lowest per capita sales of the states we surveyed.




We also analyzed the impact of sales per capita, which is determined by dividing the lottery's total revenues by the population. We found that California has the lowest sales per capita as compared to the ten states in our survey. Specifically, California's sales per capita was \$69, whereas six of the other states had sales per capita over \$135. We also found that three of these states offered numbers games which generate 30 percent or more of their lottery revenue. We believe these results reflect geographic differences of consumers. For example, the numbers games, which are also known as 3-digit and 4-digit games, are played more frequently in the eastern and midwestern states. As shown in Table 3 on page 32, total revenue from numbers games for New York, Michigan, and Illinois range from 30 percent to 44 percent of their sales. In contrast, California earned 4 percent of its revenue from numbers games. However, geographically, California's portion of sales attributable to numbers games is similar to other western states such as Oregon and Washington. Furthermore, neither Arizona nor Colorado offer numbers games.

State Controller's Office Needs To Improve Its Relations With and Value to the Lottery



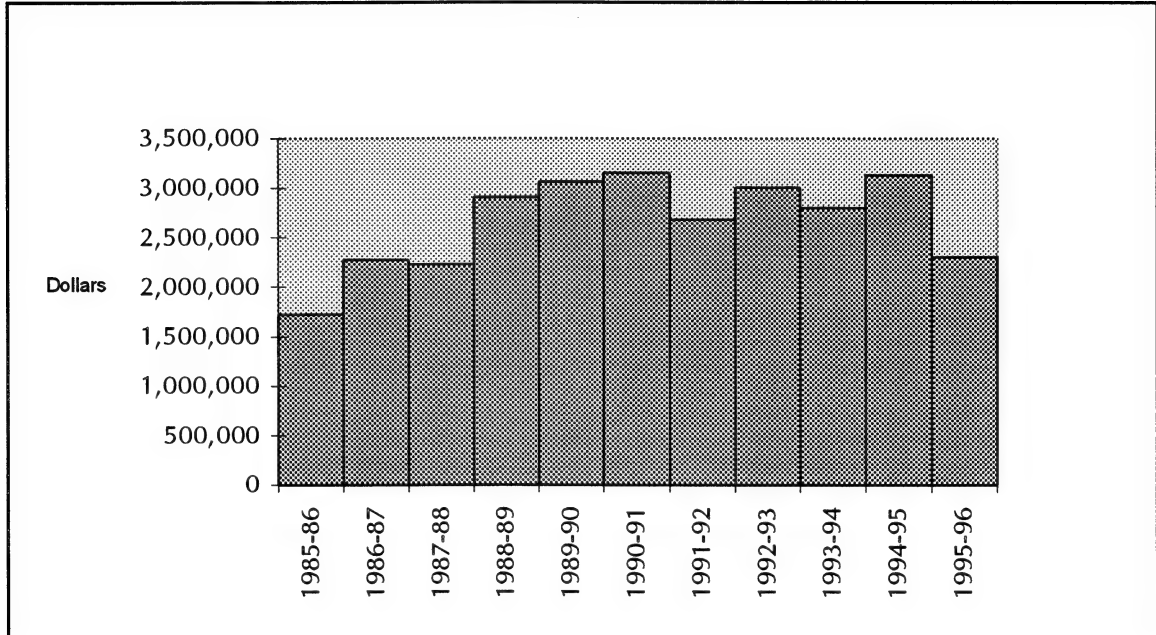
The SCO has charged the lottery over \$29 million for its services during the past 11 years.



Another component of the lottery's operating costs included services provided by the SCO. These services, which generally comprise only 2 percent of the lottery's operating costs, include field audits, electronic data processing (EDP) audits, and claims processing. The SCO has charged the lottery over \$29 million for these services over the period the lottery has been in existence. Annual amounts range from \$1.7 million in fiscal year 1985-86 to \$3.2 million in fiscal year 1990-91. Figure 4 shows the SCO's charges to the lottery over the past 11 fiscal years.

Figure 4

**SCO Charges for Services
Fiscal Years 1985-86 Through 1995-96**





The SCO charged the lottery a total of \$3.1 million in fiscal year 1994-95 and \$2.3 million in fiscal year 1995-96. Table 4 shows the elements of the SCO's charges for fiscal year 1995-96.

Table 4

**Elements of SCO Charges
Fiscal Year 1995-96**

Division	Amount
Accounting	\$ 144,000
Audits (includes field audits, EDP audits, monitoring and support)	1,390,000
Information Systems	454,000
Information Security	126,000
Administrative Services	93,000
Disbursements (preparation of prize warrants only)	127,000
Total SCO Charges Fiscal Year 1995-96	\$2,334,000


The SCO has not always responded to the lottery's requests for budget and cost information.


Usually at the beginning of the fiscal year, the SCO informally provides the lottery with an estimate of how much it will charge in total for services to be provided during the fiscal year. According to the lottery, this amount has not been a negotiated amount. In a letter dated June 12, 1996, the lottery requested the SCO to provide it with the 1996-97 spending plan for lottery-related activities. The SCO's response, dated July 25, 1996, notes that the SCO projects total time equivalent to approximately 25 staff years to be devoted to functions related to the lottery's operations. However, the letter did not include a total budgeted dollar amount.

At various times, the lottery has asked for an explanation of the composition of the budget figure. For example, in a letter dated February 8, 1994, the lottery requested the SCO to provide it with a detailed breakdown of the budgeted amount for fiscal year 1994-95. In January 1995, the lottery's interim director sent a letter to the state controller requesting a meeting to discuss issues of mutual interest to the lottery and the SCO. Further, in a letter dated July 13, 1995, the lottery asked the SCO for information on the audit hours charged the lottery for financial and compliance audit engagements. According to the lottery's chief of internal audits, the lottery has not received the information it has requested. In addition, while the SCO provided the lottery with an audit plan for fiscal years 1995-96 and 1996-97, the lottery did not receive it until July 29, 1996. This is important information for the lottery to have to prepare its budget and carry out its management responsibilities.

We are concerned that there is little communication between the lottery and the SCO related to the amounts the lottery pays for the SCO services. Although we do not dispute the SCO's authority to perform audit and oversight services under Government Code Section 8880.67, we do not understand the SCO's reluctance to provide information to the lottery. The SCO's authority to perform oversight and auditing functions was included during the drafting of the initiative. However, according to a letter dated December 15, 1994, by the initiative's author, it was not the intent of the language to require the SCO to conduct its own post-audits when the lottery had already contracted with outside vendors to conduct such audits. Rather, the language was drafted to require the SCO to be the agency responsible for ensuring the audits were conducted and would be the agency to review such audits. Acting in this capacity and with this authority, the SCO is a control agency with broad powers. However, the SCO is providing services and making the bookkeeping entries to transfer money from the lottery's State Lottery Fund to the SCO's fund without the lottery having any detail as to the work

performed. At a minimum, we believe that the SCO should provide the lottery with a breakdown of the charges it incurs on behalf of the lottery.

***SCO's Field Audits Are
Often Late and of Limited
Value to the Lottery***

In fiscal year 1995-96, the SCO released two reports, one an analysis of the lottery's administrative costs and the other a compliance audit of the lottery's management of advertising contracts, which the SCO calls a fiscal review. The SCO issued this fiscal review 12 months after the completion of fieldwork. Specifically, the SCO ended its fieldwork on its review of advertising contracts on June 28, 1995, but did not issue the final report until June 13, 1996. By not providing timely information to lottery officials, the SCO hinders the lottery's ability to take appropriate corrective action as needed.

One important measure of the value of the SCO's audits is the extent that lottery management utilizes the reports to administer and guide its operations. We found that of the SCO's 48 recommendations reported in the SCO's last five audits, the lottery implemented only 6 as a direct result of the SCO's report. In responding to the SCO's audit reports, the lottery noted that it had already identified most of the problems and corrected them prior to the issuance of the SCO's report. In addition, the commission stated that the SCO's reports do not provide information that it can use to make policy decisions because the reports are not timely. Further, the commission indicated that the SCO's reports do not address areas the commission believes to be material.

Appendix B provides further details concerning the reports that the SCO issued in fiscal years 1994-95 and 1995-96, including the number of recommendations that the lottery implemented.

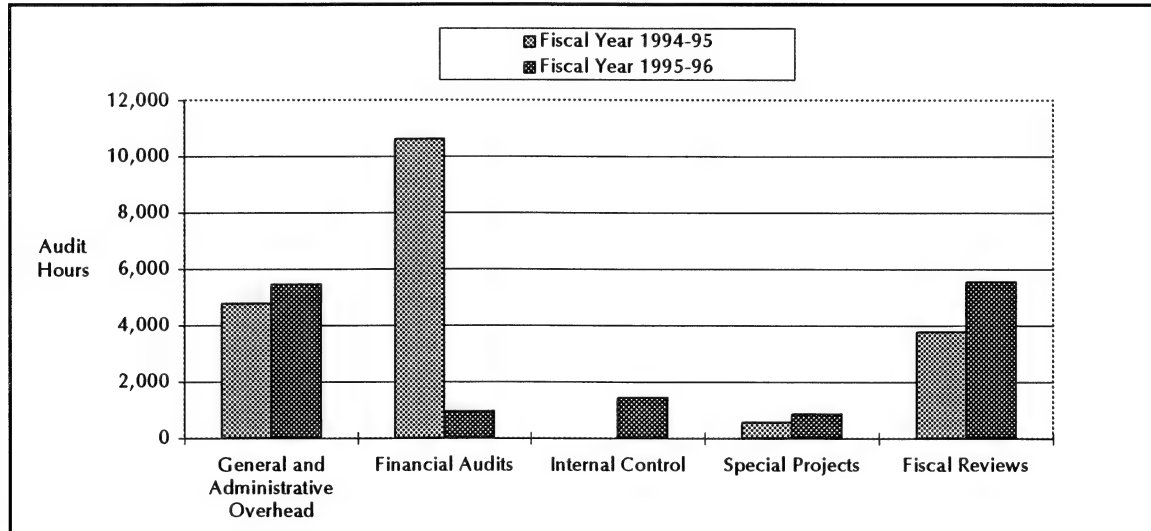
***SCO Field Audit Hours Have Decreased
but the Proportion Charged to
Overhead Has Increased***

The SCO's field audit charges for fiscal years 1994-95 and 1995-96 were for billable audit hours of 19,739 and 15,042, respectively. As Figure 5 below shows, the SCO hours for fiscal

reviews and general and administrative overhead increased in fiscal year 1995-96, while the hours for financial audits decreased substantially.

Figure 5

***SCO Field Audit Hours by Assignment Category
Fiscal Years 1994-95 and 1995-96***



We noted in our review of the field audits portion of the SCO's costs that the hours and resulting costs charged to the general and administrative cost codes increased in fiscal year 1995-96. The SCO auditors charge their time each month to specific cost codes. These codes may be specific to a particular job, such as the review of advertising contracts, or more general in nature, such as time spent on training or supervising activities. Time charged to the general and administrative cost code includes the branch chief, manager, and some supervisory time. Auditor hours charged to the general and administrative cost code might also include small projects and training.

The total charged to the general and administrative cost code by 14 field auditors alone in fiscal year 1994-95 was 4,832 hours for a cost of \$277,771, which is 24 percent of the total field audit hours. The total charged in fiscal year 1995-96 increased to 5,455 hours reflecting a cost of \$341,863, which is 36 percent of the total field audit hours. According to the SCO, 743.5 hours of the increase relate to the SCO charging the time of one trainee to the general and administrative cost code rather than to a specific lottery job cost code. We believe that if the auditor performed substantial audit work related to the lottery,

SCO should apply the hours to the applicable project cost code. Furthermore, the general cost code hours and costs discussed here do not include the time charges and costs of the EDP audit staff or the monitoring staff, who also use these cost codes.

If the 743.5 hours are deducted from the 5,455 general and administrative hours for fiscal year 1995-96, the total hours charged to the general and administrative cost code decrease to 4,711.5. While this is 120.5 hours less than the hours charged in the prior year, it is 31 percent of the total field audit hours as compared to 24 percent in fiscal year 1994-95. Furthermore, while the SCO reduced total field audit hours by 4,697 hours, or 24 percent, field audit general and administrative hours decreased by only 120.5 hours, or 2.5 percent. Although we would not expect hours charged to the general and administrative cost code to decrease in exactly the same proportion as total field audit hours, a 2.5 percent reduction appears low.

***The SCO's Audit Plan for
Fiscal Year 1996-97 May
Include Duplicative Work***

The SCO plans to continue its on-site auditing function at the lottery during fiscal year 1996-97 and estimates billable hours at 14,680. The SCO prepared a two-year audit plan covering fiscal years 1995-96 and 1996-97 and provided it to us on July 16, 1996. The lottery received a copy of the same plan on July 29, 1996. Beginning with fiscal year 1995-96, the SCO no longer performs financial audits because a performance audit of the SCO reported that its financial audit work at the lottery duplicated the work performed by the lottery's independent financial auditor.


The audit plan does identify specific audits that the SCO plans to work on during fiscal year 1996-97. The SCO plans to perform the second half of its internal control audit of the lottery that it began in fiscal year 1995-96, conduct two build-upon audits, complete six fiscal reviews, and begin three additional fiscal reviews. The SCO plans to devote 4,200 hours of the total 14,680 hours to the build-upon audits and defines them as audits where it performs whatever additional work it believes is necessary to bring the assurance level of the audits up to what is required by government auditing standards or to perform more work where it believes the audit coverage was inadequate. At the SCO's current rates, this equals \$243,222. The two scheduled build-upon audits are related to the annual financial audit, which is performed by an independent certified

public accountant, and the biennial security audit, which is performed by an independent firm experienced in security procedures. The lottery obtains contracts for both the annual financial audit and the biennial security audit through its competitive bidding process.


In describing the build-upon financial audit, the SCO notes that its objectives are to reduce to a minimum the risk of not performing its own financial audit of the accounts and transactions of the lottery. The SCO's results will dictate whether it can accept the work of the independent certified public accountant in meeting the SCO's responsibilities under the lottery act. To gain that reliance, the SCO plans to review the working papers related to the audit, perform a quality control review of the certified public accounting firm, and perform additional work to meet government auditing standards.

The SCO notes that it relies on the biennial security audit to ensure that major automated systems are secure from unauthorized access and exposure. The SCO plans to review the work performed by the firm, identify audit security concerns, and follow up on corrective actions implemented by the lottery. Since the lottery's Internal Audits Office currently performs follow-up on the implementation of the security audit's recommendations, this appears to be a duplication of its work. The SCO also notes that its review may also lead to additional internal control work where it believes the audit coverage to be inadequate.

Our concern is that at the SCO's current billing rate, the estimated hours planned for build-upon audits will effectively double the costs of the mandated financial and security audits for the lottery. Specifically, the contracted financial audit for fiscal year 1994-95 cost the lottery \$106,000; the proposed SCO financial work using the estimated hours from the SCO's audit plan and the billing rates of the assigned staff for fiscal year 1995-96 will cost the lottery nearly the same amount, practically doubling the cost of audit services. Similarly, the contracted security audit that was issued in August 1995 cost the lottery \$111,000; the proposed SCO security work, using the estimated hours from the audit plan and the billing rates of the assigned staff for fiscal year 1995-96, will cost the lottery an additional \$147,000 and may not provide any additional information. Because of the significant costs and limited additional value involved in these build-upon audits, we question the cost benefit of these reviews.



The SCO plans to commit \$243,222 in audit resources to assess the adequacy and build upon two audits conducted by independent firms, more than doubling the lottery's costs of \$217,000.



Conclusion

The lottery's administrative costs are limited to 16 percent of annual sales revenue and fall into two broad categories: game costs and operating expenses. Game costs are directly tied to lottery sales and, using preliminary expense numbers, represented approximately 9.7 percent of sales during fiscal year 1995-96. For the same period, operating expenses represented approximately 5.8 percent of sales.

Due to pending litigation over the legality of the Keno game in California that ultimately resulted in the Keno game being suspended in June 1996, the lottery developed a budget contingency plan for fiscal year 1996-97. Anticipating the loss of the Keno game, the lottery reduced budgeted sales revenues by \$400 million, which then required the lottery to reduce its budgeted operating costs by \$30 million. The lottery has further reduced its budgeted operating costs by \$6.1 million in response to the loss of Scratcher vending machine revenue. Because of significant uncertainties related to its revenues for fiscal year 1996-97, we believe that the lottery should continue to take aggressive action to monitor and reduce its administrative spending.

Based on our survey of other states, California's lottery operations are similar in many respects to those of other states when gaming mix and other factors are taken into consideration. We also noted that California has the lowest lottery sales per capita of the states we surveyed.

Over the past 11 years, the SCO has charged the lottery over \$29 million for the performance of its audits and claims processing services. However, the SCO has not provided the lottery with details related to the composition of the total cost or the specific services to be provided. Although the lottery has made several attempts to obtain more detailed information, the SCO has not responded to its requests. Consequently, the lottery does not have all the information it needs to fulfill its management responsibilities. Further, the SCO does not always provide the resulting audit report to lottery officials in a timely manner, which reduces the value of the reports to the lottery.

Finally, the SCO's audit plan for fiscal year 1996-97 includes the performance of two build-upon audits related to the annual financial audit and the biennial security audit, which are both performed by external independent contractors. The SCO's intention is to review the work of the external auditors and perform any additional work that it believes is necessary. The SCO's reason for performing the build-upon financial audit is to

reduce the risk of not performing its own financial audit of the lottery. The SCO's reason for performing the build-upon security audit is primarily to follow up on corrective actions implemented by the lottery. However, the lottery has its own Internal Audits Office that performs follow-up on the implementation of audit recommendations. Therefore, the SCO's efforts appear to be duplicative. In addition, the costs the SCO will charge to perform these build-upon audits will more than double the cost of audits mandated by the lottery act, even though it appears that the SCO's reports will provide limited additional value.

Recommendations

To fulfill its responsibilities related to its administrative expenses, the lottery should continue its efforts to:

- Monitor and reduce its administrative expenses; and
- Ensure that an open line of communication exists with the SCO.

To fulfill its responsibilities under the lottery act, the SCO should:

- Ensure that an open line of communication exists with the lottery;
- Respond to the lottery's requests for information concerning the SCO's charges and audit plans in a timely manner, ensuring that the information provided is sufficient to enable the lottery to fulfill its management responsibilities;
- Use separate codes for its field audit costs related to monitoring, EDP audits, and general and administrative overhead; and
- Carefully assess the audit work it plans for fiscal year 1996-97 to ensure that it is not duplicative of existing work.

Chapter 3

The California State Lottery Can Increase the Efficiency of Its Sales Division

Chapter Summary

A key factor that impacts the overall success of the California State Lottery (lottery) involves the performance of its Sales Division. The Sales Division accounts for about \$19.4 million, or 28 percent, of the lottery's operating expenses each year. The Sales Division's goal is to maintain an adequate retailer network to provide steady annual increases in sales and revenue for education. This goal is facilitated primarily through the efforts of the district sales representatives (DSRs) and the telemarketing representatives (telemarketers). However, our review disclosed that the lottery can make its product distribution process more efficient. For example, we identified instances of duplication of effort. In addition, the lottery may not be using its telemarketers and DSRs most efficiently. Further, we believe that the sales goal incentive programs for the DSRs and the telemarketers are not equitable.


Some of the Responsibilities of the District Sales Representatives and the Telemarketing Representatives Are Duplicative

Some of the responsibilities of the DSRs and the telemarketers are duplicative. Specifically, both the DSRs and the telemarketers contact each of the retailers to answer questions and to provide information on the lottery's new Scratcher games. Retailers normally order Scratcher tickets through the lottery's Telemarketing unit. The lottery has contracted with United Courier Incorporated Distribution Plus for the delivery of the lottery's Scratcher tickets to retail locations, but the DSRs pick up unsold tickets at the end of a game.


Each telemarketer is assigned to specific retailers within a certain geographic area. The telemarketers contact the high- and medium-sales volume retailers once per week and the low-sales volume retailers at least once per month. The telemarketers' primary responsibilities are to solicit sales of

Scratcher tickets and to provide courteous customer service to retailers. Currently, the assigned volume of calls per day limits the services the telemarketers can provide. Specifically, the lottery's 37 telemarketers are responsible for making about 120 calls per day. We calculate that with this quota, telemarketers can devote, on average, less than four minutes per call. Consequently, the telemarketers currently can do little more than sales maintenance as opposed to sales enhancement. In addition, from the eight responses to our survey of other states, we noted that California's ratio of one telemarketer to every 636 retailers is higher than the ratios in four other states. For example, the ratio of telemarketers to retailers in Florida is one telemarketer to every 336 retailers and is one telemarketer to every 316 retailers in Illinois. Therefore, California telemarketers contact 89 percent more retailers than Florida and 101 percent more than Illinois.

The DSRs visit high- and medium-sales volume retailers on-site approximately every two weeks and visit low-sales volume retailers once per month and at least at the beginning and end of every Scratcher game. For the past two fiscal years, the sales force has consisted of 184 DSRs who work out of 13 district offices located throughout the State. The DSRs directly account for the distribution of 5 percent of the Scratcher tickets. According to the director of the Sales Division, the DSRs have more influence over the sales levels of the instant Scratcher games than any other game. However, we were unable to quantify how much of the 95 percent of Scratcher distribution to retailers accounted for by telemarketers is influenced in some way by the DSRs.



Both telemarketers and DSRs are responsible for maximizing the sales of Scratcher tickets to the same customers.



Similar to the telemarketers, the DSR's primary responsibility is to maximize ticket sales within his or her territory. As the lottery's primary link with the retailer, the DSR is also responsible for developing promotions designed to help retailers sell more tickets and distributing point-of-sale advertising items to retailers, such as door decals, posters, or window banners. In addition, the DSR is responsible for picking up unsold tickets at the end of a game or when the retailer stops selling lottery products, and recruiting new lottery retailers. Each DSR is assigned a sales territory which is based on retailer ZIP codes. However, these territories can change due to fluctuations in the number of new and closing retailers, which in turn causes a reassignment of ZIP codes.

California's ratio of sales representatives to the number of retailers is higher than that of five of the eight states we surveyed. Specifically, California's ratio of one sales representative to every 114 retailers exceeded the ratios for Colorado, Florida, New York, Texas, and Washington.

The ratios for these states range from a low of one sales representative to every 78 retailers to a high of one sales representative to every 111 retailers.

***Product Distribution Costs
Could Be Reduced by Increasing
Efficiency of Sales Staff***

The cost of the lottery's product distribution staffing includes, but is not limited to, the costs of the DSRs and telemarketers. There are 184 budgeted DSR positions compared to 37 telemarketer positions. The DSRs have more responsibilities than telemarketers and are compensated at a significantly higher pay. For fiscal year 1995-96, the average salary and employee benefits of DSRs was \$47,880, compared to \$33,492 for telemarketers. Table 5 shows that total cost of salaries and employee benefits, incentive programs, and travel for DSRs far exceeds that of the telemarketers.

Since some of the needs or concerns of retailers can be adequately addressed by the telemarketers, we believe the lottery should consider reducing the number of retailers that DSRs routinely visit. This alternative is a cost-effective option that will minimize unwarranted site visits and allow the lottery to concentrate its efforts on those retailers who truly require specialized attention. This alternative also reduces the DSRs' workload which will allow them to focus on actively recruiting new retailers with a potential for high-volume ticket sales, as well as on working with existing retailers with a potential for increasing sales or expanding the product lines carried. Further, the DSRs would be more available to resolve retailers' problems and make special-purpose visits, when referred by a telemarketer.

◆
*Since some sales needs
can be addressed by
telemarketers, DSRs
should reduce routine
visits and focus on
working with retailers to
increase sales or expand
product lines carried.*

◆
If the lottery reduces the number of retailer visits, it can focus the primary responsibilities of DSRs to working with retailers to increase the retailers' sales to consumers. This alternative would make better use of the DSRs' knowledge of their territories and the retailers' customer base. With the DSRs working with retailers to generate additional customer sales, the lottery would benefit by additional sales to the retailers. However, implementation of this suggestion would require the lottery to establish alternative methods for delivering point-of-sale advertising and picking up unsold ticket stock from some retailers.

In addition, if the lottery refocuses the DSRs' responsibilities, it may be able to maintain or increase its sales with fewer DSRs and thus lower the cost of sales. If the lottery chooses to reduce the number of DSR site visits, it should also consider increasing the number of telemarketers. This would reduce the volume of calls assigned to each telemarketer and allow them to spend additional time providing essential information about new Scratchers and high-selling games, and possibly enhance sales performance.

Finally, the implementation of the Scratchers automation project may also result in additional ways for the lottery to make its product distribution system more efficient. Specifically, the lottery plans to reduce its sales force by 24.5 positions as a result of this project. This includes 7 telemarketers and 10 DSRs. In light of the proposed changes we have discussed, the lottery should reevaluate the proposed sales force reductions to obtain the optimal mix of telemarketers and DSRs.

Table 5


***Comparison of Sales Revenue to Costs
Fiscal Years 1994-95 Through 1996-97***

	Actual 1994-95	Preliminary 1995-96	Budgeted 1996-97
Scratcher Sales	\$566,420,564	\$599,666,217	\$590,000,000
Sales Costs:			
DSR			
Salaries and benefits	\$ 8,621,808	\$ 8,809,897	\$ 8,806,092
Incentive programs	387,250	875,000	960,000
Travel	209,301	210,478	336,020
Subtotal	9,218,359	9,895,375	10,102,112
Telemarketing			
Salaries and benefits	1,071,096	1,105,244	1,129,653
Incentive programs	16,574	29,300	40,000
Travel	2,964	2,823	4,000
Subtotal	1,090,634	1,137,367	1,173,653
Total Scratchers Sales Cost	\$ 10,308,993	\$ 11,032,742	\$ 11,275,765


As part of our analysis of the benefits the lottery derives from both DSRs and telemarketers, we conducted a statewide survey of 26 retailers. We selected 2 retailers from each of the 13 districts, including retail store chains as well as privately owned businesses, that offer on-line, instant lottery games, or

both. We asked retailers for their opinion of the overall benefit received from the lottery's approach to disseminating product information and ticket distribution. The approach includes retailer contact with the DSRs, telemarketers, and the receipt of lottery product information mailings.

Our survey disclosed that 16 of the 26 retailers, or 62 percent, felt the DSRs provide the most value; however, 6 of the 26, or 23 percent, believed the DSRs and telemarketers provide similar value, and 4 of the 26, or 15 percent, received the most value from the telemarketers. The results of our survey, in addition to our cost analysis and comparison of California's staffing to that of other states, lead us to believe that the lottery can rely more on its telemarketers to provide its primary contact with its retailers for orders and Scratcher information without a loss of sales. For those retailers who need on-site visits, and for recruitment of new retailers, the DSRs would remain the main point of contact. Moreover, according to our marketing consultant, selling through telemarketers is generally more efficient in terms of time, effort, and expenses than selling through personal visits.



Selling through telemarketers is generally more efficient in terms of time, effort, and expense. For those retailers needing on-site visits, DSRs should be the main point-of-contact.




The survey also disclosed that the DSRs personally deliver packages with information on new Scratcher games as part of regular sales calls. We believe a more effective use of the lottery's resources can be achieved by mailing the product information to the retailers prior to the telemarketers' calls. This allows the retailers to become familiar with the structure of the new games and develop questions that can be addressed by the telemarketers during the normally scheduled call.

While both the DSRs and telemarketers provide valuable services to the retailer, multiple contacts with each retailer may not be the best use of the lottery's available resources. For example, some retailers may not require site visits by DSRs to adequately address their needs or to provide information on new Scratcher games. Furthermore, according to our marketing consultant, the conventional wisdom has it that customers (or, in this instance, the retailers) may give the order to the telemarketer but expect hand-holding from the personal-visiting sales representative. However, experience would indicate that the more willing the retailer is to carry the merchandise (or, in this instance, to feature the Scratcher), the less necessary the personal visit. Moreover, there is a strong correlation between the effectiveness of telemarketing and the consumer's acceptance of a product: if the product is in demand by the consumer, the retailer is eager to carry the product.


The Lottery's Incentive Programs Are Not Equitable

We also evaluated the components of the sales goal incentive programs that the lottery provides to its DSRs and telemarketers. Nationwide, 15 of the 37 lotteries, or 40 percent, offer various types of incentive programs to their sales forces. In fiscal year 1995-96, the DSRs had two incentive programs consisting of Scratcher product sales goals and the Business Building Incentive Program for Keno recruitment. However, the June 24, 1996, California Supreme Court decision that Keno was an illegal banking game has caused the lottery to eliminate the latter incentive. Therefore, the DSRs currently have the Scratcher product sales goal program and the telemarketers have the Heartbeat of the Lottery incentive program.

The goals of both incentive programs are primarily based upon increased sales volume; the incentive period is 13 weeks; and nonachievement of these goals is not considered a negative in evaluating an employee's job performance. However, our comparison of the two incentive programs disclosed several apparent disparities that the lottery should be aware of when assessing the programs for reasonability and equability.



Incentives for telemarketers, paid in gift certificates, may total \$400 per quarter. DSRs' incentives, paid in cash, can reach \$3,000 per quarter.



Specifically, the lottery's methods of paying the DSRs and telemarketers differ. As shown in Table 6, there are five levels of achievement for DSRs and three levels for telemarketers. The incentives for telemarketers are paid in the form of gift certificates redeemable at selected stores whereas the DSRs receive cash payments. More importantly, the award amount paid to DSRs and telemarketers who achieve or exceed their goals differ and appear inequitable. For instance, the highest achievable award for telemarketers is \$400 per quarter, whereas DSRs can achieve up to \$3,000. Moreover, the lowest level DSR sales goal yields a minimum award of \$500 per quarter which is \$100 more than the top telemarketer award.

The DSRs also receive credit toward the achievement of their goals from the telemarketers' sales generated within their sales territory. In addition, the incentive program for telemarketers is voluntary whereas the DSR program is incorporated into their employment bargaining agreement. Finally, the DSR incentive program does not incorporate achievements in increasing low-volume retailer sales or the recruitment of new lottery retailers. This information is already available in the lottery's information system, so the ability to measure the DSRs' achievement of these goals would not involve significant cost to the lottery. According to our marketing consultant, good incentive programs will reward several combinations of goals.

Further, incentive programs can be based on a variety of goals, including total sales, total sales plus a percentage increase, new accounts opened, or new products sold.

Table 6

***Lottery Sales Incentive Programs
Fiscal Year 1995-96***

Achievement Level	DSRs ¹	Telemarketers ²
Level 1	\$ 500	\$200
Level 2	750	300
Level 3	1,000	400
Level 4	2,000	N/A
Level 5	3,000	N/A

¹Incentives paid in dollars
²Incentives paid in gift certificates

Table 7 shows that the total cost of the incentive programs for DSRs is significantly higher than that of telemarketers. The incentive program costs for DSRs in fiscal year 1995-96 increased by \$487,750 from the prior fiscal year because more DSRs achieved their sales goal in fiscal year 1995-96 than in the prior year. Specifically, the number of awards to DSRs that achieved their goals in one or more quarters increased by 136. Moreover, the number of awards to DSRs who achieved the highest level sales goal in one or more quarters increased from 30 to 196. These factors resulted in a significant increase for the DSR incentive program costs.

Table 7

***Incentive Program Costs
Fiscal Years 1994-95 and 1995-96***

	1994-95	1995-96
DSRs	\$387,250	\$875,000
Telemarketers	16,574	29,300
Difference	\$370,676	\$845,700

The recent ruling by the state attorney general that the use of Scratchier vending machines is illegal has impacted the sales of Scratchier tickets and the incentive programs for both the DSRs and telemarketers. Specifically, sales goals for DSRs and six of the eight goals for telemarketers are adversely impacted by the loss of Scratchier vending machines because the goals are based on increased Scratchier ticket sales. As a result, the lottery needs to reevaluate the basis of its entire incentive program.

Conclusion

Our review of the lottery's product distribution process disclosed several issues. For example, some of the responsibilities of the DSRs and the telemarketers are duplicative. Both the DSRs and telemarketers contact the retailers to answer any questions and to provide information on the lottery's new games. We believe the multiple contacts with each retailer may not be the best use of the lottery's available resources. Also, the lottery may not be using its DSRs and telemarketers most efficiently. Finally, the lottery's incentive programs for the DSRs and telemarketers are not equitable. Both the incentive amounts and the methods of payment to DSRs and telemarketers differ significantly.

Recommendations

To improve the efficiency of its Scratchier distribution process, and the equability of its sales incentive programs, the lottery should consider implementing the following alternatives:

- Reduce the number of retailers routinely visited by DSRs to allow the DSRs to focus their attention on retailers whose sales can be increased. In addition, if it reduces the number of retailers that DSRs routinely visit, the lottery should also consider reducing the number of DSRs, thus lowering the cost of sales.
- Use the telemarketers as the primary point of contact for the majority of its retailers. In addition, the lottery may need to lengthen the telemarketers' calls to accommodate additional sales efforts related to new Scratchier games and high-selling games. If the lottery chooses to use telemarketers as the primary point of contact for its retailers, it should consider increasing the number of telemarketers.

- Redirect the responsibilities of the DSRs to primarily work with retailers that have the potential for increased sales, those that have registered a complaint or request that cannot be handled over the telephone, and those that have expressed an interest in selling lottery products. This alternative would result in the lottery using different methods for delivery of point-of-sale advertising and the pick-up of unsold ticket stock at the end of games.
- Mail packets with information on new Scratchier games to the retailers rather than having the DSRs deliver the packets during their routine visits.
- Modify the sales incentive programs for equability. Also, the lottery should consider adding goals to the DSR incentive program that relate to increasing sales at lower-volume retailers and the recruitment of new retailers.
- Consider these alternatives when implementing the Scratchier automation project because there may be further opportunities to make the lottery's product distribution system more efficient with fewer resources.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG
State Auditor

Date: August 22, 1996

Staff: Elaine Howle, CPA, Audit Principal
Nancy Woodward, CPA
Christine Berthold
Robert Langhi
Phyllis Miller, CPA
Kathleen Sergeant

Appendix A

Evolution of the California State Lottery's Strategic Planning Process Fiscal Years 1985-86 Through 1996-97

Fiscal Year	Document	Comments
1985-86 through 1993-94	Annual Business Plans	Marketing plans developed by the marketing division with little input from other divisions.
1993-94	Vision 1999	A document that provides an outlook of what the lottery envisions itself to be in 1999. However, it is not a complete long-term strategic plan.
1993-94	Lottery 1994— "The Next Step"	A two-year plan that defines the lottery's mission and includes action plans for 24 projects to improve the internal operations. This plan does not include specific sales goals.
1994-95 through 1995-96	Annual Business Plans	Plans prepared by the sales and marketing divisions and reviewed by the lottery's business planning committee. These plans continued to have a sales and marketing focus.
1996-97	Comprehensive Annual Business Plan	A two-part plan that includes a corporate plan prepared by the lottery's business planning committee, and a divisional plan that incorporates goals, objectives, and action plans for all of the lottery's operating divisions.

Appendix B

State Controller's Office Audit Reports Fiscal Years 1994-95 and 1995-96

Report Title	Reporting Period	Issue Date	Number of Findings	Number of Recommendations	Number Implemented	Lottery Response				
						A	B	C	D	E
Internal Control as of December 31, 1993	July 1993 to December 1993	December 1994	6	11	4	4	5	2		
Internal Control as of June 30, 1994	July 1993 to June 1994	June 1995	3	3	0			3		
Broadcasting Contracts	January 1991 to December 1993	October 1994	4	19	0		3		12	4
Telecommunications Contracts	July 1993 to June 1994	June 1995	3	3	1	1				2
Advertising Contracts	July 1993 to March 1995	June 1996	4	12	1	1	5	1		5

Key to Lottery Responses to Recommendations:

- The lottery agreed with the recommendation and will implement.
- The lottery agreed with the recommendation; however, the issue had been previously discovered by lottery personnel and the corrective action was implemented prior to the issuance of the report.
- The lottery agreed with the recommendation; however, the issue had been previously reported on and addressed by the SCO.
- The specific findings and recommendation cited in this report were not individually addressed by the lottery. However, the lottery did make a blanket statement that the "majority" of the findings and recommendations in the report had been addressed and corrective actions implemented prior to the report being issued.
- The lottery disputed the finding. Specifically, the lottery asserted that the finding was not based on fact and that the SCO's recommendation was already part of the lottery's procedures.



California Lottery

Headquarters

600 North Tenth Street

Sacramento, CA 95814

August 19, 1996

Mr. Kurt Sjoberg
State of California Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

Thank you for the opportunity to respond to the California State Auditor's performance audit of the California State Lottery (CSL). We sincerely appreciate the professional manner in which your staff conducted this audit. I commend you and your staff for a productive, valuable, and comprehensive assessment of our operations. In particular, I am pleased that the CSL's contract and procurement policies are in order and compare favorably with the State Procurement Act. You recognize that the CSL has made significant improvements in the annual business planning process and is taking aggressive fiscal steps to respond to the recent loss of Keno and the decision regarding the use of our Scratchers® vending machines.

As you have noted, the CSL was proactive and, we believe, conservative when we adopted a contingency budget for the 1996/97 Fiscal Year, reducing revenues by \$400 million and administrative expenses by nearly \$30 million. In addition, within days of the unexpected Attorney General's determination on the use of Scratchers vending machines, the CSL made further reductions in its administrative expense authority by reducing another \$6.1 million. We will continue to closely monitor our expenses, as well as continue our efforts to restructure and rebuild the organization consistent with all applicable state laws.

I would like to point out that the dollar amounts used throughout your audit report are preliminary and unaudited numbers which do not reflect year-end accruals. These numbers will change following accrual entries. Our official numbers will not be available until after the conclusion of the 1995/96 year-end financial audit.

We generally concur with your findings and your suggestions as to how the CSL can improve its planning. In response to your recommendations, I have directed the CSL management team to:

- Revise and improve the CSL's long-term strategic plan by including specific goals and objectives to help direct future operations. Where the Business Plan and Management Plan documents appear to have inconsistencies or discrepancies, we will consider combining them into a single document, improve the proofreading process, and ensure that priorities are clearly identified and that divisional plans address actions required by the corporate goals.
- Set additional benchmarks and targets for product and game categories, as appropriate, where increases in sales can be isolated and quantified.
- Include internal resource requirements, such as staffing and equipment purchases, in divisional action plans.

With regards to the efficiency of the Scratchers distribution process, we believe that the District Sales Representatives (DSR) and Key Account Specialists (KAS) should continue to be the primary point of contact for our retailers. Our past business reviews have shown that successful sales strategies were sold-in to the retailers through the DSR and KAS interaction. For example, our retailer in-counter devices, vending machines, and higher price point Scratchers games required on-site demonstration to effectively make the sale to retailers. Also, our experience indicates that direct mailing of packets with information on new Scratchers games to retailers is not as effective as the DSRs personally explaining the information. Although the CSL does not fully agree with the auditors' conclusions in this area, it will continue to evaluate and implement various programs to determine the optimum ratio of DSRs and Telemarketers to retailers for the most efficient, effective, and economical product distribution process.

The CSL appreciates the information included in your report regarding the State Controller's Office (SCO) expenditures and audit activities relating to the CSL. Ultimately, unnecessary, unjustified and duplicative audits result in fewer dollars transferred to education. We look forward to finding ways to reduce redundancy and receive greater value for the audits the SCO performs.

Again, I thank you for an informative audit of our programs and activities. We look forward to your review of the CSL's use of information technology.

Sincerely,



Maryanne G. Gilliard
Interim Director



KATHLEEN CONNELL
Controller of the State of California

August 20, 1996

Mr. Kurt R. Sjoberg
California State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

I am pleased to forward to you my office's response to the portions of your draft report on the California State Lottery which relate to the State Controller's Office.

The recommendations contained in your draft report are supportive of the direction, mission, and priorities that have guided the Controller's Office in its relationship with the Lottery since the completion of the performance audit that I ordered upon taking office. However, it is disappointing that the draft report focuses heavily on past problems in the SCO-Lottery relationship which have been addressed by my administration. The attached response references some of the actions the SCO has taken. For example, SCO charges to the Lottery have been reduced by 26% and through a cooperative relationship with the Lottery, 86% of our audit recommendations have been implemented. (1)*

The need to improve the relationship between the SCO and the Lottery became sharply defined in May 1995, following the conclusion of the performance audit of the SCO. A fundamental change in the relationship between the SCO and the Lottery was clearly needed. This change was a challenge given that during the previous ten years, certain work styles and management routines had become entrenched. However, the hard work, enthusiasm, and energy of both veteran and new SCO staff members has resulted in progress over the past year.

As is indicated in our response, the SCO refutes numerous inaccuracies and misleading statements in the draft report, including both findings and the isolated paragraphs which precede them. Your findings represent a fundamental misunderstanding of the facts and an inaccurate depiction of the SCO and its current relationship with the Lottery. The greatest areas of concern are: the Lottery's implementation of the SCO recommendations; the value of SCO's work for the Lottery; administrative costs; and projected audit activities. Each of these issues has been addressed in our attached response. I am confident that, upon your review, you will wish to amend your report. (2)

*The California State Auditor's comments on this response begin on page 67.

Additionally, since the portions of the draft received were transmitted in isolation, the opportunity to review the report as a whole has not been provided; therefore, the attached comments may need additional clarification once the final report is available for our review.

The draft report's recommendations related to the SCO's audit activity with the Lottery reinforce the changes that I ordered in May 1995, changes that have since been implemented. I am confident that in continuing to work with the Lottery, we will further the strong management principles and clear communication that is now the basis of our SCO-Lottery relationship.

If you have any questions about the enclosed response, please feel free to contact Helen M. Shepherd, Chief Deputy Controller, Finance, at 310-342-5678.

Sincerely,

A handwritten signature in cursive script, reading "Kathleen Connell".

KATHLEEN CONNELL
State Controller

encl.

cc: Helen M. Shepherd, Chief Deputy, Controller, Finance

STATE CONTROLLER'S OFFICE

AUDIT RESPONSES

AUGUST 20, 1996

The SCO disputes the findings of the draft report, which contains inaccurate information and erroneous interpretations of data.

State Controller's Office Response to BSA Isolated Paragraph 1:

The BSA auditors found no deficiencies in the documentation for charges levied by the SCO for Lottery work. (3)

State Controller's Office Response to BSA Isolated Paragraph 2:

The warning regarding duplicative work for fiscal year 1996-97 is unwarranted and should be omitted as there is no historical evidence to suggest that this Controller's administration would perform work that is duplicative. (4)

State Controller's Office Response to BSA Isolated Paragraph 3:

The last two sentences of this paragraph are repetitive of isolated paragraph. (5)

BSA Finding: *The State Controller's Office Needs to Improve Its Relations With and Value to the Lottery.*

State Controller's Office Response:

This finding stems from past problems involving the exchange of financial information between the CSL and SCO. It is important to recognize that the current administration of SCO has made correction of these past practices a top priority. The SCO has opened the lines of communication with the CSL to provide it with the appropriate planning, budget, and cost information it requires. Through its audits and review activity, as well as meetings with Lottery officials and staff, the State Controller's Office has been engaged in a concerted effort to assist CSL in improving its fiscal effectiveness. (6)

With respect to the SCO's Lottery-related costs, prior Controller administrations' costs may have been trending upward; however, under the current Controller, they have been *reduced*. An independent audit of the State Controller's Office was ordered by the Controller and completed in May 1995. That audit recommended -- and the SCO adopted -- specific cost-saving measures in this area. These measures resulted in lowering SCO's Lottery-related costs from \$3.1 million to \$2.3 million from fiscal year 1994-95 to fiscal year 1995-96 -- *a reduction of 26 percent*. Changes

to reduce expenditures on financial audits that were duplicative were responsible for a reduction of approximately \$200,000.

The State Controller's Office is also concerned that statements in this finding imply that SCO may have charged CSL inappropriately. In fact, the BSA's auditors reviewed the SCO's documentation and *identified no deficiencies*. (7)

The BSA report cites the author of the Lottery initiative to explain the "intent" of the Lottery Act and to question SCO's audit responsibilities under the Act. The author's statements of intent are irrelevant. In fact, Government Code Section 8880.67 requires the SCO "to conduct quarterly and annual post audits of all accounts and transactions of the Commission and other special post audits as the State Controller deems necessary." (8)

Finally, the BSA's use of the word "value" in the heading of this finding is unfounded. Since the issue of "value" is not addressed in the text of the finding, the SCO is unable to respond. The serious implications of such language require that it either be substantiated with specific references or edited. (9)

BSA Finding: *SCO's Field Audits Are of Limited Value to the Lottery.*

State Controller's Office Response:

The issue of late reports was addressed by the State Controller's Office in 1995 as a result of the Controller-initiated audit of the office. Steps were initiated to reduce the backlog and improve delivery time.

The BSA's assertion regarding the value of SCO's work is highly irregular because it bases the value of an audit solely on actions taken by an auditee *after* a final report is issued. As the BSA acknowledges in its own publication, "Many times the corrective action is started even before we finish our audit" (*An Overview of the Auditor General's Operations, July 1992*). In numerous instances, the CSL has acted on SCO's findings and recommendations before the final report was issued and sometimes while the fieldwork was in progress. The BSA did not include corrective actions taken prior to issuance of a final report in its count of "implemented" recommendations. Instead, the BSA claimed that "few" of SCO's recommendations were implemented and, therefore, concluded incorrectly that the audits had limited value. (10)

In four of the five audit reports cited by the BSA, 86 percent of SCO's recommendations were implemented (25 of 29) at some point after the audit work was initiated. This high percentage supports SCO's strongly held contention that SCO does, in reality, provide excellent value to CSL, facilitating necessary corrective action to improve its operations. In the fifth report, in which the Lottery did not respond to individual findings, a percentage cannot be determined. (1)

The current SCO administration already has identified that audit resources in the past were not focused on the areas of greatest need. The plan set forth by the SCO for the upcoming fiscal year directs resources to these areas and cuts the duplicative work as recommended in the Controller's

performance audit. Furthermore, in recognition of the importance of Lottery Commission oversight, the SCO plans to meet with the commissioners in the near future.

BSA Finding: *SCO Field Audits Hours Have Decreased But Proportion Charged to Overhead Has Increased.*

State Controller's Office Response:

This finding cites conditions and data relative to SCO's charges to various audit activities for the Lottery. Since it identifies no clear problem, it is difficult to respond. As such, the finding is unsupported and should be abandoned. However, as part of the improvements specified in the Controller's performance audit, the SCO has implemented a refined tracking system for audit hours.

11

BSA Finding: *The SCO's Audit Plan for Fiscal Year 1996-97 May Include Duplicative Work.*

State Controller's Office Response:

The SCO's audit plan for 1996-97 was developed to meet its audit responsibility in accordance with Government Code Section 8880.67. The SCO audit staff are well versed with professional auditing guidelines relative to accepting the work of other external auditors (currently KPMG) and the internal auditors. Contrary to BSA characterization, the biennial security reviews were not "audits" as no working papers were maintained. The BSA has not identified any instance of duplicative audit work initiated by this SCO administration. Thus, this finding, which is based solely on an assumption of future action, is unnecessary and inappropriate.

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Comments

California State Auditor's Comments on the Response From the State Controller's Office

To provide clarity and perspective, we are commenting on the State Controller's Office (SCO) response to our audit report. The following numbers correspond to the numbers we have placed in the SCO's response.

- ① We identified 48 recommendations the SCO made in five reports. In its response, the SCO has chosen to ignore one of these reports that has 19 recommendations, none of which the California State Lottery (lottery) implemented. Additionally:
- 7 recommendations were disputed by the lottery;
 - 6 were recommendations that repeated recommendations the SCO made in prior audits;
 - 7 recommendations were identified and implemented by the lottery before the SCO provided information based on its audit work;
 - 3 recommendations were based on recommendations developed and reported by the lottery's Internal Audits Office; and
 - 6 recommendations were implemented by the lottery as a result of the SCO's audit reports.

Therefore, the lottery implemented 6 of 48 recommendations reported by the SCO. This is 12.5 percent of the recommendations, not 86 percent as the SCO asserts.

- ② We disagree with the SCO and believe that our report represents an accurate statement of the facts. Our statement is supported by our point-by-point rebuttal of each of the SCO's issues in the "Audit Responses" document.
- ③ The SCO is referring to a paragraph in our Summary that briefly describes our findings. We do not imply that the SCO inappropriately charged the lottery. An expanded explanation of this issue is discussed in Comment 7.

- ④ Again, the SCO refers to a paragraph in our Summary where we recommend that the SCO ensure that the audit work it plans to perform during fiscal year 1996-97 is not duplicative of existing work. This point is discussed further in Comment 13.
- ⑤ In this instance, the SCO is referring to a paragraph in the chapter summary of Chapter 2. To assist the reader, we present the main points of our report in the Summary as well as in each chapter summary.
- ⑥ While the SCO contends that this finding stems from past problems, as mentioned on page 37 of our report, information regarding the SCO's planned work for fiscal year 1996-97 was not communicated to the lottery until July 25, 1996. Furthermore, the information that the SCO provided to the lottery did not include an estimated dollar amount that would be charged related to this work, or details of the planned work. Rather, the information included an estimate of the number of staff that would be assigned to functions related to the lottery.
- ⑦ Our report does not imply that the SCO charged the lottery inappropriately. Rather, as stated on page 37 of our report, we noted that despite numerous requests by the lottery, the SCO has been reluctant to provide information to the lottery. In addition, on page 38, we state that the SCO should provide the lottery with a breakdown of the charges it incurs on behalf of the lottery so that it can adequately plan and manage its administrative budget.
- ⑧ As stated on page 37 of our report, we do not dispute the SCO's authority to perform audit and oversight functions under Government Code Section 8880.67. However, we are suggesting that this authority be exercised judiciously and that the audits provide value to the lottery.
- ⑨ In the context of our report, we used the term value to encompass timely information relevant to the needs of management that will improve the efficiency and effectiveness of the lottery's operations. However, the commission stated that the SCO's audit reports do not provide information that it can use to make policy decisions because the reports are not timely and the reports do not address areas the commission believes to be material. Further, the SCO's own consultant, Peat Marwick, recommended that the SCO perform selective reviews of the lottery's operations in areas of high risk and not perform such reviews merely to incur a certain number of hours per year.

- ⑩ As indicated in Comment 9, we define value more broadly and did not base our conclusion solely on the number of the SCO's recommendations implemented by the lottery. Moreover, we always encourage the implementation of corrective action during the course of an audit and will report on any corrective action taken prior to the report date. We believe the implementation of relevant recommendations is an important performance measure of the value of an audit.
- ⑪ The statements in our report are fully supported and the fact remains that while total hours for field audits decreased for fiscal year 1995-96, the overhead costs increased. Further, in our report, we excluded electronic data processing (EDP) and monitoring hours from our analysis of field audit activities. However, the SCO charges both of these activities to the general and administrative cost code. Consequently, if EDP and monitoring hours are factored back in, overhead represents nearly 60 percent of the SCO's audit hours. Further, inasmuch as all of these hours are charged to the general and administrative cost code and are not separately captured, the tracking system is not as refined as the SCO contends.
- ⑫ The reference to biennial security audits is not a Bureau of State Audits' characterization. Rather, Government Code Section 8880.46 defines the biennial security review as an audit. Further, the SCO's own audit plan refers to the review as a security audit.
- ⑬ As stated on page 40 of our report, the SCO's audit plan identifies specific audits that the SCO plans to work on during fiscal year 1996-97. In addition, the plan clearly states that the SCO will devote 4,200 hours of the total 14,680 hours to build-upon audits of work already performed by international independent firms contracted for by the lottery. Furthermore, in its audit plan, the SCO defines build-upon audits as audits where it performs whatever additional work it believes is necessary to bring the assurance level of the audits up to what is required by government auditing standards or to perform more work where it believes the audit coverage was inadequate. Therefore, we stand by our recommendation that the SCO carefully assess the audit work it plans for fiscal year 1996-97 to ensure that it is not duplicative of existing work.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps